DISCUSSION PAPER:
SEARCHING FOR FAIRNESS

FAIR TAX COMMISSION
DE L'ÉQUITÉ FISCALE

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PREFACE

This discussion paper provides an overview of some of the issues the Fair Tax Commission will address in its final report to the Ontario Minister of Finance. The issues raised in the paper arise from a number of sources: the reports of the working groups that were appointed by the Minister to study particular issues in tax reform; information and ideas generated through the commission's public consultation program; feedback to the commission directly from the public; and the commission's own preliminary review.

The information and analysis presented attempt to focus these issues, and to place them in the context of both the objective of enhancing fairness and the limitations which must be confronted in attempting to realize that objective.

Section I describes the commission and its mandate, and places the discussion paper and the public hearings in the context of the working group reports, research and other consultative efforts that will form the background for the final report.

Sections II, III and IV review general issues that apply to all taxes.

Section II explores some of the implications of fairness issues that have been raised through working group reports and the commission's consultation program. It also addresses the issues that arise in translating principles of fairness into policy, and highlights the broadest of tax fairness issues – the mix of taxes used to fund public services in Ontario.

Section III provides information on the distribution of income and wealth. It also presents preliminary results from the Fair Tax Commission's study of tax incidence in Ontario – who actually pays the taxes in this province.

Section IV surveys the economic and constitutional limits that must be taken into account when considering fair tax reform in a sub-national jurisdiction operating in an integrated world economy.

Section V analyzes these and other issues in greater depth in relation to specific taxes. Each part of this section is written to stand on its own. It deals with:

- Residential and non-residential property taxes
- Personal income tax
- Sales tax
- Benefits taxes – gasoline and fuel taxes, environmental taxation, user fees
- Wealth taxes
- Corporate income tax
- Payroll tax
- Resource taxation – mining, forestry, farming

Section VI addresses the goal of opening up the taxation policy process to greater public involvement and scrutiny, while Section VII summarizes the role of public input in the commission's work.

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I. INTRODUCTION

The Fair Tax Commission (FTC) was established by the Ontario Minister of Finance in March, 1991 with a mandate to review the Ontario tax system and make recommendations to improve its fairness. At the same time, the Minister announced the establishment of eight working groups to investigate specific issues in tax reform and give advice both to him and to the Fair Tax Commission.

The primary goal of the FTC is to provide the government with advice concerning the design and implementation of a more equitable tax system in Ontario.

The commission was also asked by the Minister to encourage public participation in its work, paying particular attention to the need to involve those who have traditionally been excluded from the tax policy-making process.

Working groups were established to study fairness issues in corporate minimum tax, taxation of real estate gains, integration of the Ontario retail sales tax and the goods and services tax, taxation and the environment, women and tax, low income tax relief, property tax and wealth tax. Each group was made up of volunteers representing a broad cross section of interests in the specific tax reform issues under consideration. The groups brought together more than 200 people, including business executives, representatives of trade unions, farmers, educators, municipal officials, activists in social action groups, tax professionals, environmentalists, academics and members of the public.

One of the great strengths of the working groups was that they brought together people from an extremely broad range of organizations with an interest in issues related to fair tax reform. To complement the working groups, the commission has carried on an intensive consultation program designed to extend its reach to people representative of the broader public in every region in the province.

Three of the working groups submitted final reports to the Minister in March and April, 1992; four in November and December, 1992; and one in March, 1993.

Although the working groups were independently appointed to advise the Minister, their reports have contributed to the formulation of the commission's plans in a number of ways. First, research provided by the commission to working groups is an important part of the foundation for the commission's own analysis of tax fairness issues. Second, the policy directions in working group reports have assisted the commission in identifying areas of focus. Third, the diverse perspectives on taxation issues reflected in the reports of the working groups have provided the commission with valuable insights into the views of people who have not traditionally been involved in policy discussions on tax reform.

The commission's consultation program has engaged hundreds of Ontarians in 13 communities in identifying issues of particular concern to them as individuals, to the organizations with which they are connected or to the communities where they live and work. Tax forces, organized with the assistance of FTC staff, have been working at the community level for the past year. They have organized a variety of activities, from public forums and seminars to open line shows and public debates. They have produced and distributed informational material on issues of local concern and have communicated their views to the FTC through regular meetings with commissioners.

The issues raised at the community level through tax force members have already played an important role in helping the FTC to shape the agenda reflected in this discussion paper.

The views of the broader public come to the commission in various ways. Commissioners and secretariat staff have met with dozens of groups with interests either in particular tax issues or in other tax-related public policy issues. The commission has received hundreds of letters from the public, either directly or referred by members of the provincial legislature. The commission has also received dozens of formal submissions on tax fairness issues, both directly, and through the working groups. All of this communication from the public is summarized and analyzed by FTC staff, and considered by the commission in its discussions.

Along with input from the public, formal research and analysis play an important role in assisting the commission in formulating its recommendations.

Staff studies and contracted research projects have been designed to assist the commission's work. The first series of studies analyzes the economic environment of the 1990s within which tax reform takes place in Ontario and explores ideas of fairness as they apply to tax reform at the provincial level. A second focuses on the current tax system and its impact on Ontarians. A third reviews and analyzes the constraints faced by Ontario as a sub-national jurisdiction as it pursues tax fairness in a federal political structure and in an increasingly interdependent economic world. A fourth was designed to assist the commission in thinking through specific taxation policy issues that have been identified through working groups, input from the public and the findings of the research program itself.

In addition to playing an important role in assisting the commission in formulating its recommendations, the results from these studies will be made public during the life of the commission as a contribution to the public debate about options for fair tax reform. Summaries of the studies will be available as soon as the papers are finalized. The complete studies will be published by the University of Toronto Press in a series of volumes organized thematically.

Now, the task of the commission is to think through this information, along with the further public input that emerges from the commission's hearings this spring, to come up with workable approaches to improving the fairness of Ontario's tax system.

Its specific goals are:

- to identify the important tax-fairness issues and situate them in a broader tax reform framework;
- to suggest how those issues might be resolved in a world without constraints; to make explicit how constraints limit Ontario's (or perhaps even Canada's) ability to implement these solutions; and
- to identify a package of reforms that achieves our fairness goals within those constraints.

In its pursuit of these goals, the commission must test long-standing assumptions and conventional wisdom against the data that describe the tax system as it exists today. It must respond thoughtfully to taxpayers' concerns without accepting the day-to-day political and economic limitations of the political process. At the same time, it must take into account the economic and constitutional constraints that limit Ontario's ability to create a fair tax system.

In its public hearings, scheduled for April, May and June of this year, the commission invites the public to participate in thinking through the complex issues that must be addressed in the search for tax fairness.

This discussion paper is intended to raise the issues that have been placed before the commission and to place those issues in a broader context. It is also designed to encourage those who participate in the public hearings to reflect on the goal of fair tax reform together with the constraints and limitations that Ontario faces in its search for tax fairness as they formulate their own positions for presentation to the commission.

II. Issues in Defining Fairness

This section of the discussion paper explores some of the tax fairness issues identified by people in the commission's consultation process.

Popular perceptions of tax fairness

Ask most people about tax fairness, and they say their taxes are too high. Ask why they think that, and they are likely to talk about two things: the value that they get from government for their tax dollars; and the amount of tax they pay compared with the amount of tax others pay. For most people, the idea of tax fairness is closely linked both to the value they place on the services that government provides and to the perception that others are paying less than their fair share of taxes.

For society in general, taxation depends on choices made collectively about what goods and services should be provided through government, about what proportion of the income of society should be redistributed among its members and about how the revenue needed to provide those goods and services should be raised. These choices reflect fundamental ideas about the kind of society we want. Although the decisions are political, in a democracy they should reflect broadly accepted social values. The democratic process tests those values constantly and measures the performance of our institutions against those values.

The Fair Tax Commission is focusing on one of these basic democratic questions: How should the cost of providing public services be distributed among taxpayers?

Despite this focus on how taxes are shared within society, however, issues related to the overall level of taxation and government spending do come into any consideration of tax fairness. For example, the overall level of taxation in Ontario plays a role in an analysis of the impact of taxes on business decision-making and individual migration.

Government spending comes into the picture both because some tax provisions are really substitutes for expenditure programs and because society's view of tax fairness generally cannot help but be influenced by the distribution of the benefits from public spending. But the core of the commission's work concerns how the costs of providing public services are shared.

When it comes to this basic question of fairness, people generally start from their own experience. Tax unfairness is often exemplified by others paying less than their fair share of taxes and, occasionally, by others paying more than their fair share. Few would argue they pay too little tax; most would argue they pay too much. However, as strongly held as these views may be, society's thinking about tax fairness cannot be based on these individual perceptions because they cannot all be valid unless the overall level of taxation is too high, in which case, the problem would be one of democratic accountability, not tax fairness.

It is also difficult to separate debate about the goals of fairness from debate about the economic or social consequences of

pursuing those goals. For example, a debate about the taxation of capital gains can turn very quickly into one about the potential consequences of a policy change for investment, entirely bypassing the issue of fairness. Similarly, a debate about the taxation of social assistance benefits very quickly becomes one about the adequacy of the benefits themselves. These questions are clearly relevant to how much fairness we can achieve in the tax system without producing undesirable and unacceptable side effects, but they confuse the underlying tax fairness issues.

Defining principles of fairness

In order to come to grips with the basic questions of tax fairness, we have to identify some generally acceptable values or principles to help us separate fairness issues from issues of self-interest, and to separate issues that relate to the goals of fairness from those that relate to the consequences of attempting to achieve those goals. In a society whose economy functions through the exchange of goods and services for a price, the natural starting point in this search for fairness is to look for a tax that is a fair price for public services, one that fairly reflects their value to the individual taxpayer.

The problem is that most of the things governments do cannot be priced to the individual. The effect of most government programs is either to deliver a good or service that is of general benefit to society, or to redistribute economic resources among the members of society. Some programs – police protection at one extreme; social assistance, perhaps, at the other – involve only one or the other of these basic functions. Others, such as education combine elements of both.

To the extent that the purpose of a program is to deliver goods or services of general benefit to society, it is often impossible to determine how the benefits from the program are distributed among individual members of society. To the extent that the purpose of a program is to redistribute economic resources, it is relatively easy to determine who benefits from the program. However, it would clearly frustrate the purpose of the program to charge a tax based on the benefits received.

When it is either impossible or inappropriate to allocate the costs of public programs among people based on the benefits that they receive from those programs, it is necessary to come up with an acceptable alternative.

Although the range of choices potentially available for the allocation of the costs of public programs among taxpayers is virtually limitless, most of them offend values that are fundamental in a liberal democracy. As a society, we tend to object to measures that are either arbitrary or discriminatory. We also believe in general that taxation should be related in some systematic way to the taxpayer's ability to pay.

Ability to pay

Taxation based on ability to pay has two dimensions. First, it suggests that taxpayers in similar economic circumstances should pay similar amounts of tax. This principle, equal treatment of equals, is referred to by economists as horizontal equity. Second, it suggests that taxpayers in different economic circumstances should pay different amounts of tax that

reflect appropriately their differences in economic circumstances. This principle, appropriately unequal treatment of those who are not equal, is referred to by economists as vertical equity.

To Canadians, the most easily recognized expression of the concept of horizontal equity, or equal treatment of equals, comes from the Royal Commission on Taxation (Carter Report 1966). Carter's phrase, "a buck is a buck" stands for the general idea that taxpayers whose ability to pay is the same should pay the same tax, or that all income should be taxed in the same way regardless of its type or source. While this principle seems so straightforward it appears to be obvious, it raises very difficult questions.

How should the ability to pay of taxpayers be measured? Should the comparison be based on income? On consumption? On wealth? Over what time period should we measure ability to pay? At the time of a particular transaction only? Over a year? Or over a longer period of time that recognizes the reality that people's ability to pay can vary from year to year?

Although there is a great deal of debate about these questions in principle, as a practical matter, annual income is generally accepted as the basis for comparison of taxpayers' ability to pay. Even after resolving this problem, however, other questions remain to be answered:

- Should the comparison be based solely on the economic resources available to the taxpayer, or should it take into account special responsibilities of the taxpayer or the taxpayers' non-discretionary expenditures, such as those related to care for children?
- Who is the taxpayer? Is it an individual or an economic household?
- Is a buck really a buck? Does a dollar of income from employment confer the same ability to pay as a dollar of income from bond interest or a capital gain?
- Self-employment offers taxpayers opportunities that are not available to employees to organize their affairs to minimize tax. Does that make income from self-employment different from employment income?

When questions such as these are resolved, the principle of equal treatment of equals, or horizontal equity, provides a prescription for an element of tax fairness.

The principle of vertical equity, appropriately unequal treatment of those who are not equal, does not provide a simple prescription. To translate this principle into a prescription for tax fairness, it is necessary to define what we mean by appropriately unequal. Should everyone pay the same share or proportion of their income in tax, regardless of income? Such taxes, levied at the same rate regardless of income, are called proportional taxes. So-called "flat taxes" on income are examples of proportional taxes.

Or is it enough that taxpayers with higher incomes pay higher taxes than taxpayers with lower incomes, even if taxpayers with higher incomes pay a smaller share of their income in tax? Taxes that decline as a proportion of income as the taxpayer's income increases are called regressive taxes. A tax can be regressive even if the same rate of tax is paid by everyone, if it results in people with lower incomes paying a greater share

of their income in tax than people with higher incomes. For example, a tax on food would be regressive because even though higher income people spend more on food than lower income people, they spend a smaller proportion of their income on food.

Alternatively, is it appropriate that the share of a taxpayer's income paid out in tax increases progressively as the taxpayer's income increases? Income taxes, in which the rate of tax on additional income increases as the taxpayer's income increases, are examples of progressive taxes.

The traditional argument made by some economists in favour of progressive taxation is based on the idea that the additional personal benefit derived from an additional dollar of income is relatively higher at low income levels than it is at higher income levels. The higher your income, the less valuable your last dollar of income is to you. If the value of a dollar of income declines as income increases, the personal sacrifice involved in paying a dollar of tax also decreases as income increases. In this argument, progressive taxation is required to equalize the sacrifice involved in paying an additional dollar of tax.

A related argument in favour of progressive taxation is that as income increases, the proportion of discretionary income (income not required for the necessities of life) increases. In this argument, progressive taxation is required to ensure that discretionary income is taxed at a higher rate than non-discretionary income.

Other arguments in favour of progressive taxation are based on the idea that the tax system should be used to address inequality in the distribution of economic resources. These arguments imply, at a minimum, that the poorest members of society should not be required to pay tax at the same rate as those with higher incomes. Related arguments based on principles of distributive justice imply that the tax structure should be used to promote a more egalitarian distribution of economic resources in society. It is difficult to draw a distinction in these arguments between elements of tax structure required for tax fairness and elements required to equip the tax system to function as an instrument for income redistribution.

Principles of vertical equity as reflected in progressive taxation have taken a back seat in recent tax reform efforts. Instead, these reforms reflect decisions to reduce the impact of the tax system on private decisions regarding investment, saving and consumption. Some argue, for example, that it is not economically efficient to impose disincentives on those in our society with the highest incomes. Reforms based on these efficiency arguments have been made in many countries, most notably the United States and the United Kingdom, as well as in Canada.

As a result of these reforms, the tax rates faced by higher-income individuals have generally come down in industrialized nations. In addition, to varying degrees, there has been movement away from a progressive rate structure – in which rates on additional income increase as income increases – to a flatter structure, in which the rate on additional income tends to be similar, regardless of the level of income.

Society's decisions about the distribution of tax obligations among taxpayers at different income levels result from balancing social equity objectives and economic efficiency objectives.

Benefits, social costs and fairness

Although it is generally difficult to attribute the benefits from government programs to individual taxpayers, there are some programs that provide goods and services similar to those provided in the private economy. These are provided publicly either because it is more efficient to do so, or because at the same time as they provide benefits to specific individuals, they provide benefits to other people in society.

These goods and services fall into two general categories:

- Public programs that are fully equivalent to private goods and services – for example, electricity.
- Public programs that deliver benefits both to the users of the good or service provided and to others who are not users of the good or service – for example, public transit.

Taxes designed to approximate prices of goods and services provided by government are often referred to as user fees, or benefits taxes.

The most obvious example of a tax that might be considered fair according to the benefits principle is a charge, or fee, that represents the price paid by the taxpayer for the use of a public service. Examples include parking meter charges, sewer and water connection fees, transit fares and park admission charges. In some cases, it is appropriate to levy a fee that recovers the full cost of using the service, either because use of the service does not generate spill-over benefits to others (electricity rates, for example) or because once the user is connected to the service, there is no further benefit to non-users (sewer and water services, for example).

In other cases, it is appropriate to set the user charge to recover less than the full cost of providing the service, because non-users derive indirect benefits from individual use of the service. An example might be transit use, which provides benefits to non-users in the form of reduced congestion on the roads.

The benefits concept of fairness may also apply more generally to taxes that attempt to link taxes and benefits, even where the tax is not exactly equivalent to a price for the services being funded. These taxes might be designed to act as a proxy for, or representation of, certain kinds of benefits. The idea behind this concept is that if the people who pay the tax are the ones who benefit from the service, and the proportion of tax they pay is a rough approximation of the benefit they derive, the tax can be considered a benefits tax even though it does not tax benefits directly. For example, one might argue that a tax on car travel in an urban area might be a fair way to subsidize public transit, since a portion of the benefit from public transit usage flows to car users in the form of less congested roads.

The benefits principle can also be applied to taxes designed to recover costs imposed on society by the actions or decisions of individuals. For example, a tax on pollution could be seen as the price charged to industries for the use of the air and water for the disposal of industrial waste.

Conflicts among ideas of tax fairness

Generally speaking, applying the ideas of ability to pay and benefits received to the same tax will produce two different conclusions about the fairness of the tax. These two ideas of tax fairness will be consistent with each other only in the unlikely event that the pattern of use of a public service corresponds exactly to the distribution of ability to pay, as society has defined it.

In general, public programs are relatively more significant to the well-being of lower-income people than they are to the well-being of higher-income people. As a result, user charges for many public services will tend to fall disproportionately on low-income individuals and families. In other words, user charges are regressive taxes.

This conflict might be dealt with by using benefits taxes only when it can be ensured that they do not impose extreme burdens on the poor. Alternatively, governments might accept the fact that some individual taxes will inevitably be regressive, and use ability to pay as the basis for evaluating the fairness of the overall tax system, including the mix of different taxes that make up the system.

From principle to policy

Even in a world where government could pursue fairness objectives without constraints, the task of designing a fair tax system would be difficult and controversial. While fairness objectives may be stated quite simply, translating them into principles to guide tax design raises many questions, none of which are easy to answer. Some of these questions are technical; others require ethical judgements which, in turn, are linked directly to fundamental social values. Competing ideas of fairness must be resolved, not just with respect to one tax, but to a number of taxes with widely varying purposes and impacts.

In addition, various constraints must be taken into account in developing recommendations for tax fairness. Ontario is constrained constitutionally. There are some types of taxes that are not within the province's constitutional authority and others over which both Ontario and the federal government have authority. For example, only the federal government can levy customs duties, while income tax is levied on a shared basis.

Ontario's tax policy flexibility is constrained by concerns about the impact of changes made in the interests of tax fairness on other aspects of the tax system, on the behaviour of taxpayers and on other legitimate public policy objectives.

Tax policy in Ontario is also constrained by the openness of Ontario's economy to pressures both from other jurisdictions within Canada and from outside jurisdictions. Quite apart from developments such as the North American Free Trade Agreement (NAFTA), the ease with which goods and services, capital and investors can move across international boundaries imposes practical limits on Ontario's tax policy flexibility that inevitably constrain our ability to achieve fairness objectives.

Tax fairness and tax mix

In Ontario in fiscal year 1991-92, provincial and local governments together raised a total of $50.8 billion in taxes and fees of various kinds. A total of six major taxes (taxes raising more than $1 billion) contributed to provincial and local revenues.

The largest single tax – the provincial personal income tax – raised $13.7 billion, representing 25% of total revenue from provincial and local governments (FTC calculations based on *Public Accounts of Ontario 1991-92*, and data from the Ministry of Municipal Affairs).

Perhaps the most obvious tax-fairness question is: "Why do we have so many different taxes? Why can't we come up with a single tax that is considered to be fair and support all government services through that single tax?" A cynic might suggest that we have a variety of different taxes because people do not pay as much attention to a number of smaller taxes as they would to one large tax. While there is probably more than a little truth to this view, there are other reasons why we might want to have a variety of different sources of revenue.

As the discussion of fairness suggests, taxes can serve various purposes in addition to raising revenue for governments. For example, taxes on cigarettes and alcohol may have originally been levied, in part, to penalize those who use these products. Furthermore, it may be fairer to generate the funding required to pay for some types of services from taxes that can be linked to the use of the service by the taxpayer. Taxes on gasoline and motor vehicle fuel, for example, were originally conceived as a way to raise revenue for the construction and maintenance of public highways.

Different taxes may also be based on different aspects of an individual's ability to pay. Taxes on consumption are based on the idea that when people demonstrate an ability to pay for goods and services, they also demonstrate an ability to pay taxes. Some countries levy taxes on wealth, partly on the basis that an individual's wealth is an alternative measure of his or her ability to pay tax. Property taxes are also justified by some on the basis that they tax a form of wealth.

All taxes have economic impacts because they affect the behaviour of individual taxpayers. In some cases, those behavioural impacts are intended and desired by government. For example, pollution taxes are intended to encourage individuals and industries to reduce the amount of pollution they emit. Other impacts are not intended, but are the inevitable result of raising funds to support public services. One argument for a multiplicity of taxes is that small unintended behavioural changes in response to a number of taxes are preferable to significant unintended behavioural changes in response to one tax. Each individual tax will have a lower rate than it would if it were the only source of tax revenue. As a result, the response to any individual tax will also be smaller.

Multiple taxes are also advocated as a way of ensuring that everyone in society, regardless of ability to organize one's affairs to avoid paying tax, pays at least some tax to support public services. It is argued that while it may be possible to arrange one's affairs to avoid paying any single tax, it is virtually impossible to avoid paying all taxes.

Because each of the taxes collected has quite different impacts on individuals and on their behaviour, changing the mix of taxes – how the revenue-raising load is shared among various tax bases – is an important way to influence the overall fairness of the tax system.

What does it take to change the tax mix?

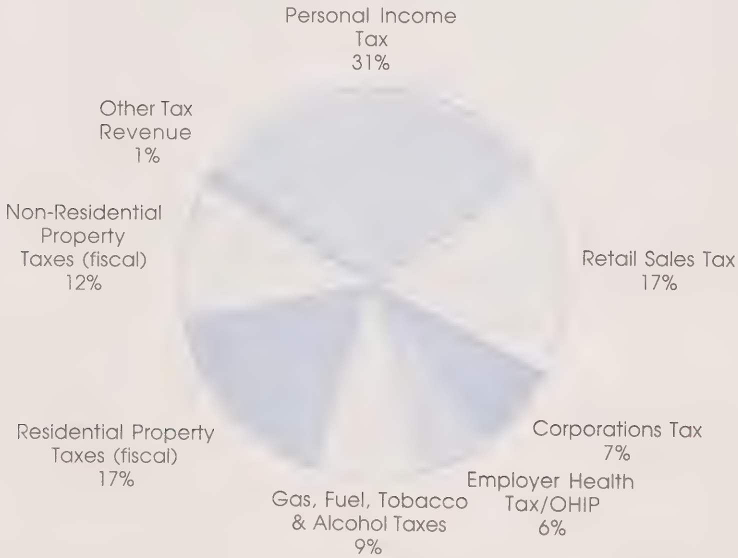
> "... *the tax system would be fairer if we just go rid of the (name your least favourite) tax.*"

> "... *we don't really need all the taxes we have; we could accomplish everything we need to with fewer taxes and less administrative hassle.*" 1

Other than the personal income tax, no single tax has a dominant impact on the fairness of Ontario's tax system. Figure 1 shows the major taxes in Ontario and the proportion of total tax revenue which they raised in 1991-92. (Note that the figure contains major taxes levied at both the provincial and local levels.) The figure reveals that other than the personal income tax which represented 31% of provincial tax revenue in 1991-92, no other major tax raised more than 20% of total tax revenue in that year.

Ontario's revenue system has evolved over time as government services have expanded and the structure of the economy has changed. Figure 2 shows the major taxes in Ontario and the proportion of total tax revenue which they raised in 1971-72. In 1971-72, the four largest taxes – personal income tax, retail sales tax, residential property tax and non-residential property tax – raised about 67% of tax revenue collected under Ontario's jurisdiction. By 1991-2, the share of these four taxes had increased to 77% of total tax revenue. Clearly these taxes together have a significant impact on the overall fairness of the tax system. Personal income taxes increased significantly as a proportion of total tax revenue, by 11 percentage points. The share of taxes on fuel, gas, tobacco

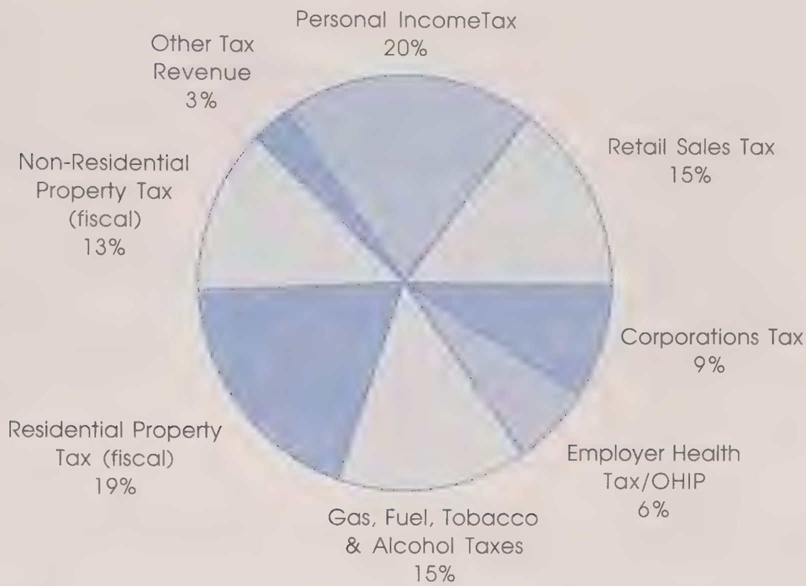
FIGURE 1
SHARES OF TAX REVENUE FROM MAJOR TAXES:
ONTARIO, 1991-92



Source: *Public Accounts of Ontario, 1991-92*; Ministry of Municipal Affairs.
Note: All data (including property tax revenues) are for the fiscal year.

1 Throughout this discussion paper, topics are introduced with paraphrases of opinions about tax fairness that were communicated to the commission in the course of its consultation program.

FIGURE 2
SHARES OF TAX REVENUE FROM MAJOR TAXES:
ONTARIO, 1971-72



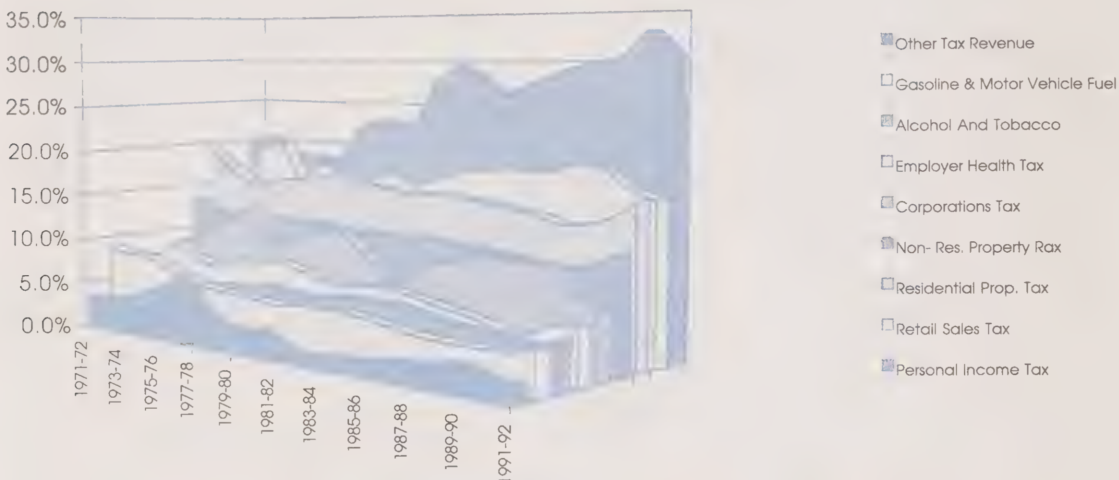
Source: *Public Accounts of Ontario, 1971-72*; Ministry of Municipal Affairs.
Note: All data (including property tax revenues) are for the fiscal year.

and alcohol, and corporate income declined by a combined total of eight percentage points.

This change in the tax mix is a result of public policy decisions that have broadened or narrowed tax bases by altering permitted exemptions or deductions, and have increased or lowered rates. For example, revenue from the personal income tax represented about 20% of total tax revenue (which includes property taxes) in 1971-72 but represented 31% by 1991-92. The proportion of total tax revenue from taxes on corporations (the corporate income tax and the capital tax) fluctuated in the 1971-1992 period, but over a longer period of time, it has declined. Corporate taxes raised 30% of total tax revenues in Ontario in 1960-61, compared to about 7% in 1991-92. Figure 3 shows the changes in the mix of tax revenue over the last 20 years.

Figure 4 provides another way of looking at the relative importance of individual taxes to the tax mix in the province by showing the actual revenue generated by the major taxes in the province. The data are in constant dollars; they have been adjusted to their equivalent level in 1990 dollars to remove the effect of inflation. The figure shows that revenue from the personal income tax and the retail sales tax has increased more dramatically than revenue from the residential property tax, the non-residential property tax, and the combined revenues from fuel, gas, tobacco and alcohol, all of which have increased at a relatively steady but lower rate. Revenue from the retail sales tax has varied with the ups and downs in the economy, a phenomenon also found with the corporations tax.

FIGURE 3
THE CHANGING TAX MIX:
SHARES OF TOTAL TAX REVENUE FROM MAJOR TAXES, ONTARIO, 1971-72 TO 1991-92



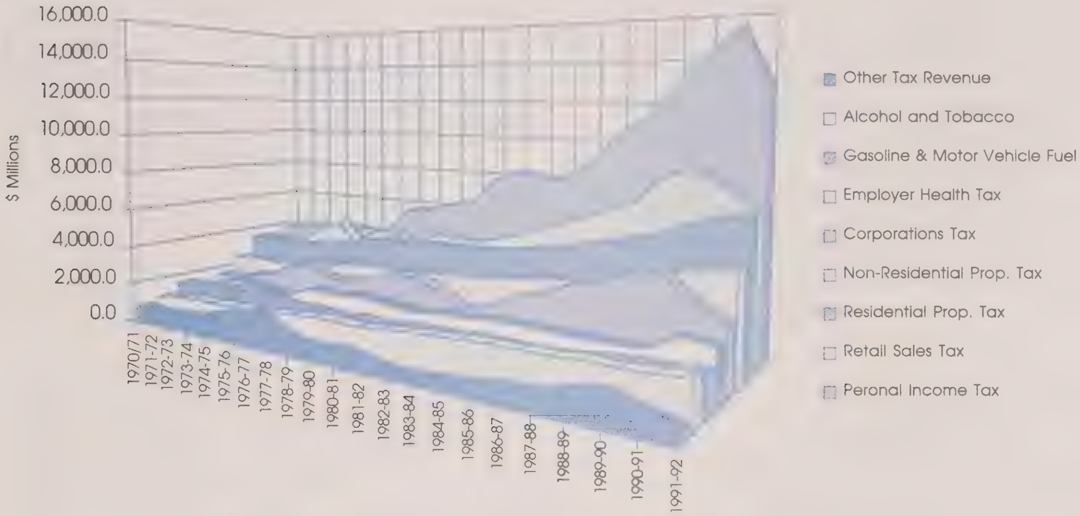
Source: *Public Accounts of Ontario, 1991-92*; Ministry of Municipal Affairs.
Note: Fiscal year data showing shares of total tax revenue for each tax. In each year, the taxes represented combine to total100% of tax revenue.

Decisions with respect to the mix of taxes in Ontario are important in the design of a fairer tax system. The various taxes differ in their relationship to ability to pay and in their impacts on the economy. At the same time, the tax mix itself imposes some practical limits. The system is a balance of a number of different taxes with varying revenue raising capacities. Some taxes have limited potential for influencing the fairness of the overall system because the revenue they raise is relatively small. Others generate such a large proportion of total revenues that a drastic change, such as eliminating the tax altogether, would require significant changes to other taxes to re-balance the system.

Table 1 shows the impact on revenue from changes in each of the major taxes in Ontario in 1991-92. For example, a one percentage point increase in the corporate income tax rate, from 15.5% to 16.5%, would have raised an additional $160 million. A one percentage point increase in the personal income tax rate, from 54.5% to 55.5% of basic federal tax, would have raised an additional $275 million. An increase in the sales tax rate of one percentage point, from 8% to 9%, would have increased revenue by $900 million. An increase of one cent per litre in the gasoline tax would have raised an additional $120 million.

Because the corporate tax base – corporate profits – is relatively small, it would take a substantial increase in corporate income taxes to balance the revenue loss from even a small reduction in the retail sales tax rate. Outright elimination of the retail sales tax would require substantial increases in one or more of the other major taxes to replace the lost revenue.

FIGURE 4
The Changing Tax Mix:
Major Sources of Tax Revenue, Ontario, 1971-72 to 1991-92 ($Million)



Source: *Public Accounts of Ontario, 1991-92*. Ministry of Municipal Affairs.
Note: All data (including property tax revenues) are for the fiscal year and are expressed in constant 1990 dollars.

TABLE 1
Revenue Impact of Selected Tax Changes:
Ontario, 1991-92 ($Million)

	1992 Rate	Rate Increase	Additional Full Year Yield	% Increase in Tax Rate
Income/Sales Taxes				
Personal Income Tax	54.5% of BFT	1 percentage point	$275	1.8%
Retail Sales Tax	8%	1 percentage point	$900	13%
Corporate Income Tax	15.5%	1 percentage point	$160	6.5%
Capital Tax	0.3%	1/10 percentage point	$140	33.3%
Payroll Tax				
Employer Health Tax	1.95%	1/10 percentage point	$145	5%
Commodity Taxes				
Gasoline Tax	14.7 cents per litre	1 cent/litre	$120	7%
Tobacco Tax	6.5 cents per cig.	1 cent per cigarette	$140	15.4%
Alcohol (Volume Levy)	*See note below	10 cents/litre	$105	57%

BFT = Basic Federal Tax

Source: Ontario Ministry of Treasury and Economics 1992; *Ontario Fiscal Outlook* ; *Public Accounts of Ontario, 1991-92* .

Notes: * Alcohol volume levies for 1992 are 17.6 cents per litre for beer, 19 cents per litre for coolers and 29 cents per litre for wine and spirits.
Full Year assumes no changes in behaviour, except for the tobacco tax.
Full Year Yield data based on 1991-92, third quarter Ontario finances.

III. Where We Are Now

How income and wealth are distributed in Ontario

"...if we just made sure that people with high incomes paid their fair share of tax, we could reduce taxes for middle-income families."

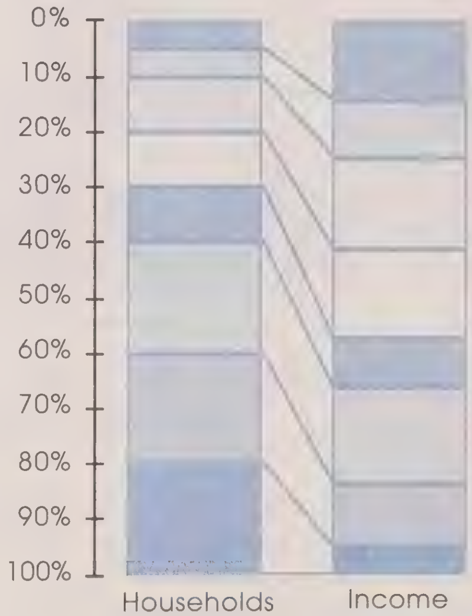
The distribution of income in Ontario from 1989 is shown in figure 5. For example, the figure shows that in 1989 the highest income 20% of households in Ontario account for about 41% of total income in the province. The lowest income 20% of households account for only about 5% of total income.

Figure 6 shows the distribution of net wealth in the province. Net wealth is total wealth after deducting all debt including mortgage debt. The figure shows that in 1989, the wealthiest 20% of households held 74% of the net wealth in the province, and the bottom 40% of households held only about 2% of the total net wealth in the province. Only 6.3 % of households in Ontario had net wealth holdings over one million dollars but those households held over 50% of the total net wealth in the province (FTC calculations based on Ernst and Young 1990).

Comparing the distribution of income and net wealth reveals that the distribution of net wealth is much more unequal than the distribution of income. While the highest-income 5% of households in the province account for 14% of the province's total income, the top 5% of net wealth holders accounted for 46% of the province's total net wealth.

A study conducted for the Fair Tax Commission of the incidence of the Ontario tax system at the household level sheds light on the impact of taxes on households (Block and Shillington 1993). Incidence studies attempt to measure how the burden of taxes is distributed among households at different income levels. In other words, they attempt to measure who actually pays taxes.

FIGURE 5
How Income is Divided:
Distribution of Household Income in Ontario, 1989



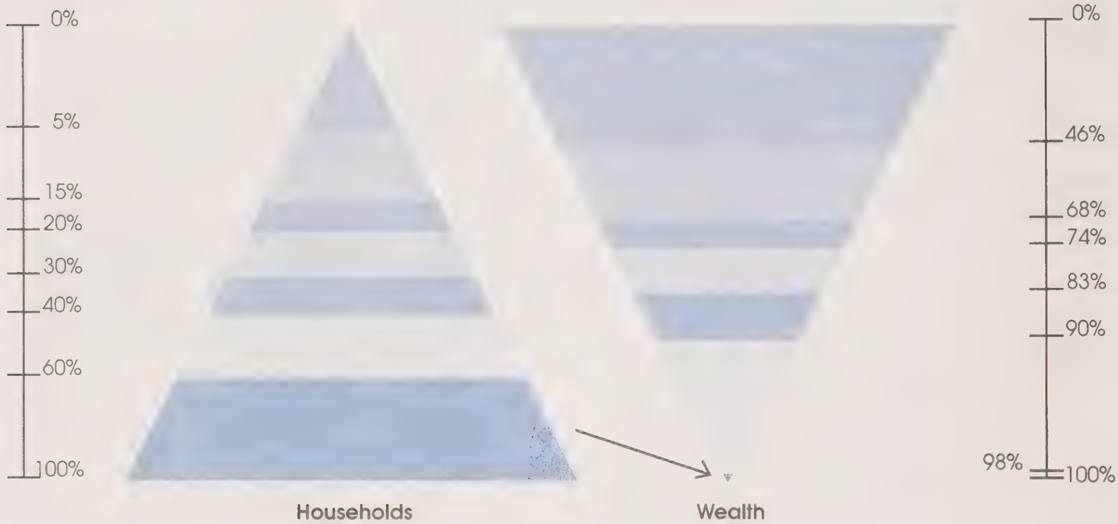
Source: FTC calculations using Statistics Canada 1990 Survey of Consumer Finances microdata files.
Note: The definition of household includes families of two or more, plus unattached individuals – as defined by Statistics Canada.

Although it sounds simple, the measurement of the income of taxpayers and of the distribution of taxes among taxpayers is a complicated exercise. There are different ways of measuring income. The results can vary with the measure of income used. Furthermore, the measurement of both income and taxes is complicated by the fact that for some transfers to low-income households, the same payment could be considered either a reduction in taxes paid or an increase in income. For example, the child tax credit could be considered as either a reduction in income tax payable, or a cash transfer from government.

In addition, incidence studies measure the impact of all taxes on individuals, taking into account the fact that businesses do not pay taxes, people do. Taxes on businesses are ultimately paid by consumers, if the taxes levied on the business are shifted forwards in the form of higher prices for the goods the business sells; employees, if the taxes levied on the business are shifted backwards in the form of lower wages for workers; or the investors who own the capital that is invested in the business, if the taxes levied on the business are shifted backwards to shareholders.

Our understanding of how these shifts take place depends on the tax under consideration, as well as the assumptions that are made concerning the operation of markets for products, labour and investment capital. These assumptions will affect our conclusions about the regressivity of taxes levied on businesses.

FIGURE 6
HOW WEALTH IS DIVIDED:
DISTRIBUTION OF HOUSEHOLD WEALTH IN ONTARIO, 1989



Source: FTC calculations based on Ernst & Young 1990, *The Wealth Report*, Vol.2, Appendix N.
Note: The definition of household in the Ernst & Young study includes all persons – even if unrelated – who share a common dwelling.

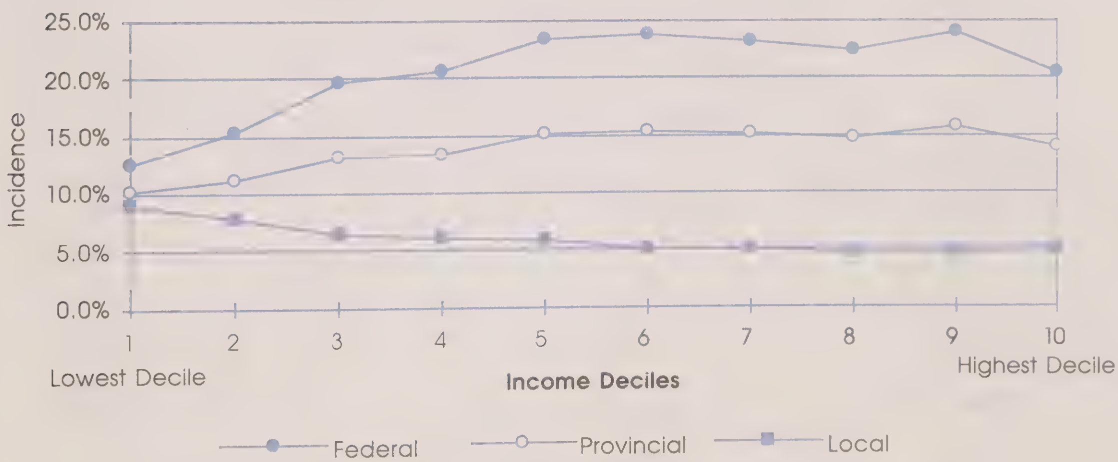
The results presented in this paper are based on assumptions about how markets work in a small economy subject to international influences. The results also reflect certain assumptions about who ultimately pays sales taxes. Some authors assume in their studies that sales taxes are not paid by consumers but are paid by employees and owners of businesses. The results presented here reflect the more usual assumption that the economic burden of sales taxes is borne by consumers.

Figure 7 compares the incidence of federal, provincial and local taxes as measured in an FTC study. Each line on the chart shows the incidence pattern across all households in Ontario of federal (●), provincial (○) or local taxes (■). Each data point shows the average percentage of household income paid by 10% of the households in the province. Decile 1 contains the 10% of households in Ontario with the lowest household incomes. Decile 2 contains the next higher-income 10% of households; and so on. Decile 10 contains the 10% of households with the highest incomes in the province.

For example, the figure shows that the economic burden of taxes for middle-income households (households in decile 5 and decile 6, or the middle 20% of the income distribution) is approximately 24% for federal taxes, 15% for provincial taxes and 6% for local (municipal and school board) taxes. By contrast, for the highest-income 10% of households in the province (decile 10), the economic burden is just over 20% for federal taxes, 14% for provincial taxes and 5% for local taxes.

The figure shows that the economic burden of local taxes is lower, the higher the income of the household. In other words, local taxes are regressive. Provincial and federal taxes are both progressive up to the middle income ranges, proportional through the middle income range and then decline as a percentage of the income between the second-highest income 10% of households and the highest-income 10% of households.

FIGURE 7
WHO PAYS THE TAXES IN ONTARIO - FEDERAL, PROVINCIAL AND LOCAL: 1991



Source: Block and Shillington (FTC) 1993, "Incidence of Taxes in Ontario in 1991".

The tax incidence pattern found in the study also varies among different categories of taxes under Ontario's jurisdiction (provincial and local taxes). Figures 8 and 9 compare the incidence patterns of the major Ontario taxes. They present the data in the same decile format as in figure 7. The personal income tax is generally progressive with the exception that in the highest-income 10% of households, the economic burden of the tax is lower than it is for the second-highest 10% of households. It is therefore regressive at the top of the income scale. The retail sales tax is regressive across all income ranges. Residential property taxes are also regressive through all income ranges. Gasoline and tobacco taxes are regressive, but less so than the retail sales tax.

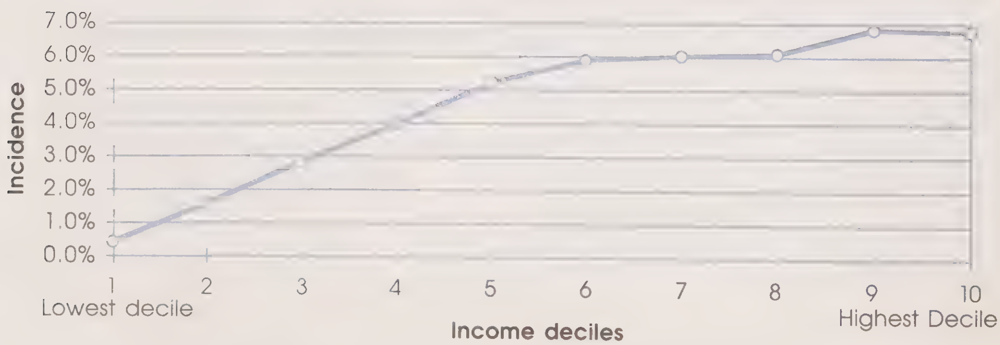
Figure 10 shows that commercial and industrial property taxes are also regressive, but less so than residential property taxes (see figure 9). The employer health tax is progressive in the lower-income ranges, is proportional in the middle-income ranges, and becomes regressive in the highest-income ranges. Capital and corporate tax are roughly proportional.

These results suggest four principal opportunities for improving the fairness of the tax system as measured by the relationship between tax and ability to pay:

- Changing the tax mix to alter the overall progressivity or regressivity of the tax system by changing the balance between progressive income taxes and regressive taxes.
- Introducing structural changes in the broadly based taxes in the tax system to alter their progressivity or regressivity.
- Introducing structural changes in these broadly based taxes to improve fairness in the treatment of taxpayers in similar circumstances.
- Introducing new taxes to the system that would alter the overall relationship between taxes and ability to pay.

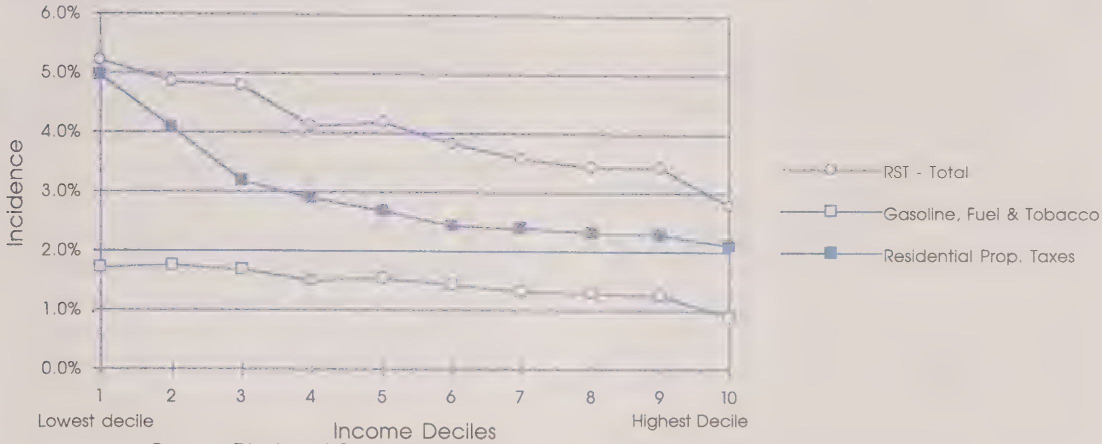
The major opportunities for change in the tax system's impact on ability to pay lie in changes in the tax mix, changes in the progressivity of personal income tax and changes in all taxes that will result in tax-

FIGURE 8
WHO PAYS THE TAXES IN ONTARIO -
PROVINCIAL PERSONAL INCOME TAX: 1991



Source: Block and Shillington (FTC) 1993, "Incidence of Taxes in Ontario in 1991".

FIGURE 9
WHO PAYS THE TAXES IN ONTARIO -
OTHER TAXES ON INDIVIDUALS: 1991



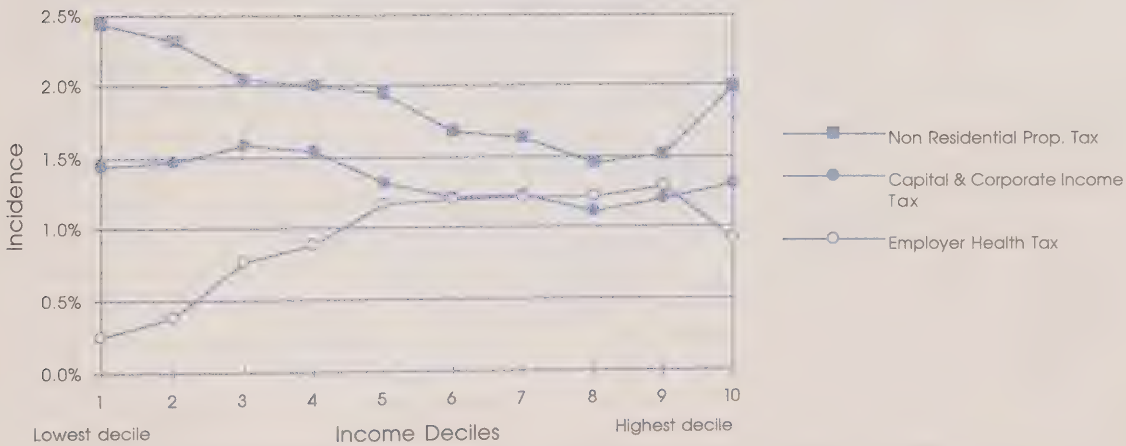
Source: Block and Shillington (FTC) 1993, "Incidence of Taxes in Ontario in 1991".

payers in similar circumstances being treated more consistently.

Fairness objectives can also be addressed for some taxes through the redesign of benefits-related taxes so tax revenues correspond more closely to the benefits received from the services being funded.

Other areas of interest for the commission include changes that can improve economic efficiency and reduce administrative costs for both governments and taxpayers without compromising fairness objectives.

FIGURE 10
WHO PAYS THE TAXES IN ONTARIO -
TAXES ON BUSINESSES: ONTARIO, 1991



Source: Block and Shillington (FTC), "Incidence of Taxes in Ontario in 1991".

What we get for the taxes we pay

> *"...middle-income people just pay and pay, and get almost nothing in return. On top of that, we're paying for rising welfare costs."*

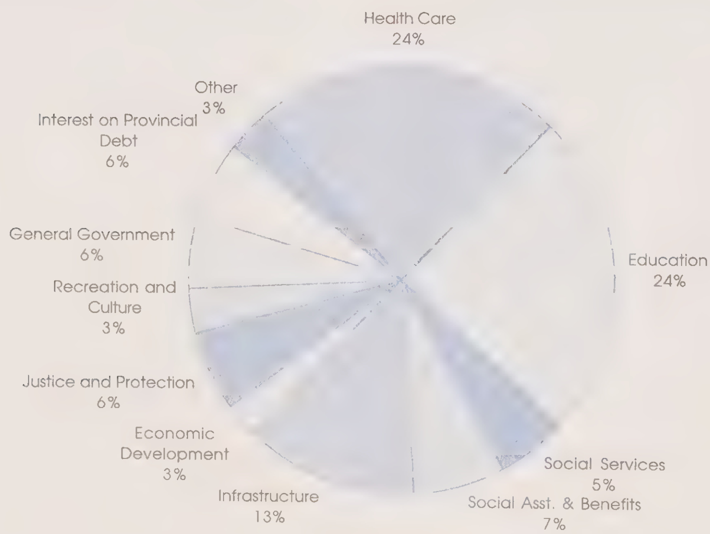
The taxes levied under Ontario's jurisdiction pay for a wide variety of services delivered at either the provincial or local level. Services and programs such as education (elementary, secondary, college and university), health care, roads, transit, water and sewer services, parks, recreation, police, fire protection and garbage disposal are also funded from taxes.

Programs to support agriculture, industry, small business development, housing, tourism, natural resource development, environmental protection and consumer protection are all funded from provincial and local taxes.

Other government roles such as the administration of justice, the regulation of financial institutions and other businesses, and the regulation of planning and development are essential to the functioning of modern society and are all taxpayer-funded.

Figure 11 shows how expenditures within Ontario's jurisdiction (provincial and local expenditures) are divided among major spending categories. It shows, for example, that out of every dollar spent by provincial and local governments combined, 13 cents is spent on infrastructure (for example, highways, roads and sewers); 24 cents on health care; 24 cents on education, including elementary and secondary education, colleges and universities; and 7 cents on welfare and family benefits.

FIGURE 11
WHERE OUR TAX DOLLARS GO:
MAJOR PROVINCIAL AND LOCAL EXPENDITURES IN ONTARIO, 1991-92



Source: *Public Accounts of Ontario 1991-92*; and Ministry of Municipal Affairs, Municipal Financial Information, 1991 (forthcoming).
Note: Numbers compiled by combining provincial, municipal and school board expenditures and netting out transfers from the province to local governments and school boards.

IV. Limits on Fairness

No one in Ontario needs to be told that economic, political and social developments around the world matter to people who live in this province. The development of the international economy in the second half of the 20th century has made the economies of individual nations increasingly interdependent. Restrictions on the movement of goods, capital and business activity have been dramatically reduced, due in part to innovations in transportation and communications, and in part to international agreements that limit a nation's ability to regulate economic relationships through such measures as tariffs and restrictions on foreign investment.

As a result, businesses, investors and individuals have a broader range of choices open to them about where to invest, where to live or locate their businesses, where to expand, where to buy and where to sell. Virtually any policy decision that government makes must, for practical economic reasons, take into account its impact on these choices.

With the increasing mobility of businesses, individuals and capital, debates in recent years about the tax system in Ontario have been dominated by the question of how our taxes compare with taxes elsewhere – in the rest of the world generally, in the United States particularly, and in the rest of Canada. Statistics claiming to compare taxes in Ontario with taxes elsewhere are sometimes cited as definitive proof that taxes here are uncompetitive. Public comment based on these analyses suggests that changes in individual taxes have immediate and dire consequences for our economy.

Determining the extent of the tax differences between Ontario and other jurisdictions is a crucial first step in assessing both the current state of our tax system and the realistic scope we have to make changes to improve its fairness. But the discussion cannot stop there.

The existence of differences between Ontario's tax system and those of other jurisdictions does not necessarily mean that those differences should be eliminated, nor does it necessarily mean that changes that create or increase differences in taxes cannot be made. We have to ask whether these differences matter to the economy, and to the extent that they do, how much weight should be put on those economic impacts.

Comparing taxes in Ontario with those elsewhere

> "*... taxes in Ontario are too high. Aren't they the highest in North America?*"

Statistics developed in tax comparison studies find their way into arguments concerning four related but distinct issues. There may be differences among jurisdictions in the overall level of taxation; in the share of tax revenue of the various types of taxes; in the taxes actually paid by similar individuals or corporations; and in marginal rates of tax (the rates of tax paid on increases in income).

In assessing the various comparisons that are made of taxes in Canada and Ontario with those in other jurisdictions, it is important to keep in mind the broader public policy issues towards which arguments based on the data are directed. For example, comparisons of the overall level of taxation may be a reliable indicator of the role of government in a society, but provide very little information as to whether taxes are too high in some jurisdictions when compared with others. The appropriateness of the level of tax in one jurisdiction can only be determined in relation to the goods and services provided by government.

Even statistics that use taxation as a measure of the role of government raise significant comparability issues. For example, comparisons that look only at taxation at the national level completely miss the differences in roles and taxation responsibilities of provincial/state and local governments. Similarly, differences in how various programs or subsidies are delivered can distort comparisons. A subsidy delivered through the tax system will not show up in the tax data used in these comparisons. The same subsidy delivered directly and paid for explicitly through higher taxes will show up in the figures.

Overall taxation/role of government comparisons

The most commonly cited statistics comparing taxes in Canada with those in other jurisdictions are compiled by the Organization for Economic Cooperation and Development or OECD (OECD 1992a).1

Table 2 presents data from the OECD which show that, including social security taxes (for public pensions, unemployment

TABLE 2
HOW TAXES IN CANADA COMPARE:
TOTAL TAX REVENUE AS A PERCENTAGE OF GDP IN OECD COUNTRIES, 1990

Sweden	56.9
Luxembourg	50.3
Denmark	48.6
Norway	46.3
Netherlands	45.2
Belgium	44.9
France	43.7
Austria	41.6
Italy	39.1
New Zealand	38.2
Finland	38.0
Germany	37.7
Ireland	37.2
Canada	**37.1**
United Kingdom	36.7
Greece	36.5
Portugal	34.6
Spain	34.4
Iceland	32.6
Switzerland	31.7
Japan	31.3
Australia	30.8
United States	29.9
Turkey	27.8
Unweighted average:	
OECD Total	38.8
OECD Europe	40.2
EEC	40.8

Source: OECD 1992a, *Revenue Statistics*, Table 1.
Note: The 1990 data for Germany include data for the former East Germany for the second half of the year. If the annexed area were excluded, the corresponding number would be 36.3%.

1 Member countries of the OECD include Austria, Australia, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Japan, Luxembourg, the Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States.

insurance and so on.), total tax revenue in Canada in 1990 was 37.1% of Gross Domestic Product (GDP) – below the average for OECD countries of 38.8%. They also show that the United States had the second lowest tax level of the OECD countries, at 29.9% of GDP. The size of the public sector relative to GDP is significantly greater in Canada than it is in the United States.

Preliminary estimates for 1991 show taxes in Canada increasing as a percentage of GDP from 37.1% in 1990 to 39.4% in 1991. For Germany, by contrast, the share dropped from 37.7% to 36.6%. If these numbers hold up in the final estimates and those for other nations do not change dramatically, Canada would move from just below the OECD average to just above the OECD average for taxes as a percentage of GDP. Two cautions are appropriate in interpreting these year-to-year changes. First, these data are preliminary estimates prepared before fiscal year-end data are available for most countries. Second, year-to-year changes are heavily influenced by short-term differences in rates of economic growth.

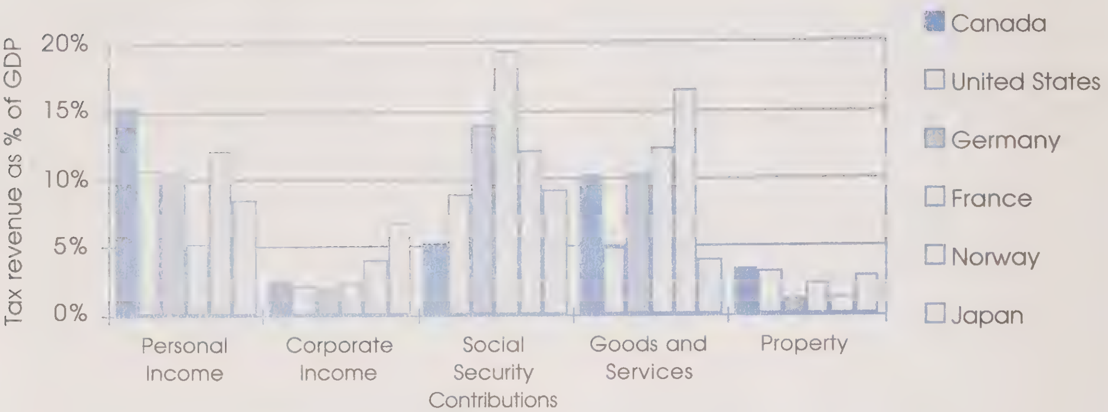
The problem with comparisons of overall tax levels for an evaluation of tax fairness is that the choices that stem from these comparisons – to lower the overall level of tax, keep it the same or increase it – are not really tax-fairness choices. They are choices about the role of government in society and the extent to which people wish to distribute resources or provide services publicly through government, rather than individually through the operation of the market.

Tax mix comparisons

Figures 12 and 13 provide two ways of comparing Canada's tax system with that of other OECD countries. Figure 12 shows how the revenue raised from each of our major taxes compares to the revenue raised in a selection of other OECD countries. To make that comparison, tax revenue is expressed as a percentage of GDP, or relative to the size of the economy. Another way of comparing tax systems is by comparing the shares of each of the major categories of taxes in total tax revenue. Figure 13 shows the revenue from each of the major taxes as a percentage of total tax revenue. The "major taxes" include social security contributions (for example, contributions to the Canada Pension Plan) and taxes on personal income, corporate income, goods and services, and property.

We know from table 2 that in 1990 Canadians paid more tax relative to the size of the economy than the Americans or Japanese, but less than the Germans, French or Norwegians. Figure 12 shows that the tax on personal income raised more revenue relative to the size of the economy in Canada than in the other countries, but that social security contributions in this country are relatively small as a percentage of GDP, compared to all other countries shown. Revenue from the taxes in Canada on goods and services was higher relative to the size of the economy than in the United States and Japan, but slightly lower than in France and Germany. Revenue from taxes on corporate income as a percentage of GDP was lower in Canada than in Norway and Japan and only slightly higher than in the United States and France. None of the countries shown raised large amounts from taxes on property, relative to the size of the economy.

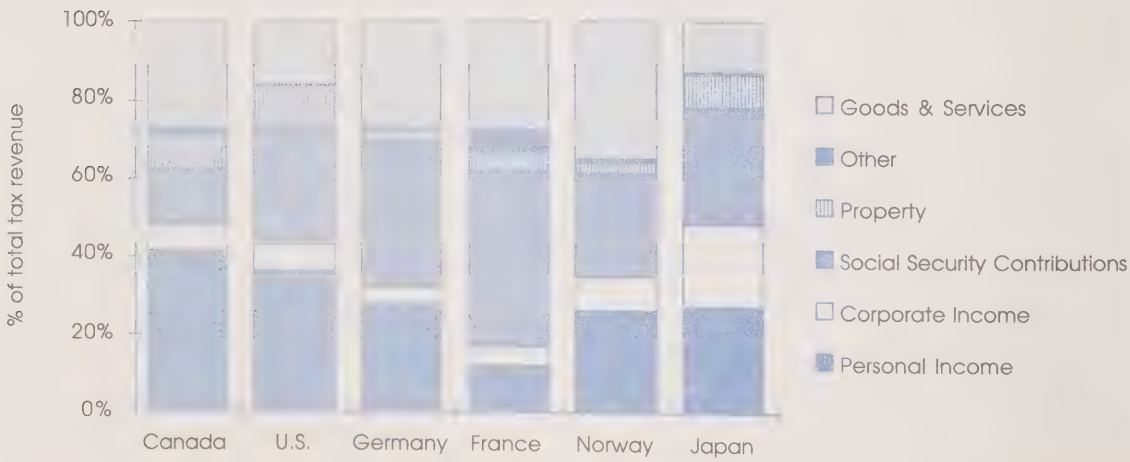
FIGURE 12
HOW TAXES IN CANADA COMPARE:
REVENUES FROM MAJOR TAXES AS A PERCENTAGE OF GDP IN SELECTED OECD COUNTRIES, 1990.



Source: OECDa, *Revenue Statistics*, Table 10, 12, 14, 22, 24.

Figure 13 shows the mix of taxes in selected OECD countries. It demonstrates the variety of combinations of taxes which governments use to fund public services. For example, of the OECD countries shown, Canada raises the largest proportion of its total tax revenue from personal income tax and the smallest proportion from social security contributions, a revenue source which dominates the tax mix in Germany and France.

FIGURE 13
HOW CANADA'S TAX MIX COMPARES:
REVENUE FROM MAJOR TAXES AS A PERCENTAGE OF TOTAL TAX REVENUE IN SELECTED OECD COUNTRIES, 1990.



Source: OECD 1992a, *Revenue Statistics*, Tables 11, 13, 15, 25.

Where taxes on personal income are progressive (that is, the share of the taxpayer's income paid out in tax increases as the taxpayer's income increases) and where the tax mix is dominated by this progressive personal income tax (as in Canada), the result is a tax mix which is more progressive overall.

It is interesting to note that Japan and the United States rely very little on taxes on goods and services, while countries which have more comprehensive social and economic support programs (Germany, France, Canada, Norway) rely on taxes on goods and services for between one-quarter and one-third of tax revenue. It is also striking that Japan relies to a greater extent on revenue from its tax on corporate income than any of the other OECD countries shown. This may be due in part to the relatively close ties between the major Japanese corporations and the government in that country.

Taxpayer comparisons

The comparisons most commonly cited in the media are those that claim to compare taxes paid by individuals and corporations in various jurisdictions, and in particular, those that compare taxes in Canada with those in the United States. These studies are subject to some of the same limitations as national level comparisons in that one cannot reach any conclusions as to which country's taxpayers are better off by looking solely at the tax data. In addition to these problems, these studies face problems in determining on a consistent basis how much tax is actually paid in various jurisdictions at the individual taxpayer level.

Such comparisons are much more complicated exercises than they appear, whether conducted for individuals or for corporations. For example, it is not sufficient to compare the rates of tax paid at various income levels. To make a fair comparison, differences in the deductions available to both corporate and individual taxpayers and differences in the tax treatment of different kinds of income have to be taken into account.

The study of tax comparisons conducted for the FTC by Ernst & Young (1992a) illustrates some of these difficulties in its review of the Fraser Institute's *Tax Facts*, a commonly-quoted annual study of tax levels in Canada (Horry, Pipes and Walker 1990). Although the main focus of the Fraser Institute study is on overall tax levels in Canada, considerable attention is paid to comparisons among provinces that suggest Ontario's taxes are the highest.

The Fraser Institute's approach is to add up all the taxes paid in a province, then divide the total amount by the number of families in that province to arrive at an average amount of tax per family. The Ernst & Young study points out significant problems with the methods used in developing the Fraser Institute data. In effect, the apparent difference the Fraser Institute finds in tax burdens from one province to another is more a reflection of different family incomes than differences in effective tax rates at similar income levels (Ernst & Young 1992a, 18-20). Their review of the Fraser Institute's numbers concludes that:

> The best one can conclude from the Fraser Institute data is that Ontario residents earn higher pre-tax incomes, pay higher taxes (in total dollars) and earn higher after-tax incomes, hardly an unattractive proposition overall for Ontario residents (Ernst & Young 1992a, 20).

Personal tax comparisons

Results from three relatively recent studies offer some insights into how taxes in Ontario compare with those in other jurisdictions:

- A comparison as of March 20, 1992, presented in the 1992 British Columbia budget, compares provincial, local and federal taxes paid by a number of different household types in Ontario, Quebec, British Columbia and Alberta (British Columbia Ministry of Finance 1992).

- An international comparison by the OECD of taxes on a "typical production worker" in the manufacturing sector shows how taxes on middle-income households compare between Canada and the United States (OECD 1992b).

- A study by Price Waterhouse compares taxes on earned income at various income levels in major Canadian and U.S. cities (Brown and Gimbert 1990).

The Ernst & Young review concludes from the British Columbia data that "the tax differences across Canada tend to be fairly modest, with provinces having low income taxes generally compensating with higher sales or property taxes" (Ernst & Young 1992a, 35).

Results from the OECD study are summarized below in table 3. It is useful to note when looking at these data that the OECD's typical production job would generate a middle-level income for a single person and an income in the lower-middle income range for a single-earner family consisting of two adults and two children.

TABLE 3

TAXES ON THE AVERAGE WORKER - HOW CANADA COMPARES:

COMPARATIVE INCOME TAX AND SOCIAL SECURITY CONTRIBUTIONS AS A PERCENTAGE OF GROSS EARNINGS FOR AN AVERAGE PRODUCTION WORKER, 1991

	Canada	**United States**	**Other OECD (Europe)**	**Other OECD (Pacific)**
Single Person				
Personal Income Tax	20.6	18.6	18.5	17.8
Social Security Contributions	4.6	7.7	10.7	4.1
TOTAL	25.2	26.3	29.2	21.9
One-earner couple - 2 children				
Personal Income Tax	12.5	11.3	12.4	13.5
Social Security Contributions	4.6	7.7	10.6	4.1
Less: Cash Transfer	(2.8)	0.0	(9.3)	(2.6)
TOTAL	14.3	19.0	13.7	15.0

Source: OECD 1992b, *The Tax/Benefit Position*, Tables 1, 3, 4.

The 1991 numbers from the OECD study show that a "typical production worker" in Canada who is single and without children pays a slightly lower proportion of income in personal taxes (for example, income tax and social security contributions) than his or her counterpart in the United States. The "typical production worker" who is married with two children, and whose spouse does not work outside the home, pays a significantly lower proportion of income in personal taxes than an American in similar circumstances. This is the case even after cash transfers (for example, the child tax credit) are factored out of the Canadian total. Unfortunately, this table does not present the whole picture. The amounts paid by people in different countries in sales taxes, property tax, and excise taxes are not included in the OECD comparison, nor is there a comparison of the government services that these taxes pay for such as universal health insurance, education, and public housing.

The study by Price Waterhouse compared taxes on earned income at various income levels in Toronto, Montreal, Calgary, New York City, Chicago and Houston. This study attempted to take into account a variety of factors that would affect income and social security taxes, including the deductibility of mortgage interest and local property taxes from taxable income in the U.S. income tax system (Brown and Gimbert 1990).

The focus of the Price Waterhouse study was on the tax that would be paid by an individual who relocated across the Canada-United States border. For lower- and middle-income taxpayers, the differences in taxes are relatively small in comparison to the additional benefits to Canadians from tax-provided public services such as pensions (Old Age Security, Guaranteed Income Supplement) health care and lower tuition fees for higher education.

Health care and better pension benefits relative to contributions are each estimated in the Price Waterhouse study to have had a value in 1989 to the average Canadian family of approximately $3000. For middle-income taxpayers, the estimated $6000 benefit from these two programs offsets the higher income taxes paid in Canada as compared with those paid by middle-income taxpayers in the United States.

In fact, this offsetting impact may be understated. In Ontario, basic hospital and doctor coverage and the drug benefit program alone paid benefits in 1991-92 of approximately $1335 per capita. For families with two adults and two children, whose taxes are compared in the Price Waterhouse study, this value translates to a benefit to the family of $5340. This amount understates the value of Ontario's publicly provided health programs to the Ontario taxpayer because it excludes such programs as nursing home care and because equivalent health services cost more to provide in the United States than in Canada, due to higher administrative costs.

Ernst & Young's review for the FTC concludes as follows:

> The Price Waterhouse study tends to confirm the OECD data findings that Canadian personal income taxes are higher overall, and that upper and upper-middle income earners bear this difference. Income taxes in Ontario (federal and provincial combined) are far more progressive than those in the United States, at least for earned income. The interprovincial comparisons suggest that Ontario taxes are very slightly higher than those of Alberta, but much lower than those of Quebec (p. 23).

The Price Waterhouse study deals with taxes on earned income only. It notes, but does not include in its calculations, areas in the taxation of income from capital where Canadian taxpayers receive more favourable treatment than their U.S. counterparts, such as the $100,000 lifetime capital-gains exemption, the inclusion of only 75% of capital gains in income, the exemption of capital gains on the sale of a principal residence and the dividend tax credit. In addition, the comparisons do not reflect the fact that the United States has a gift and estate tax, while Canada does not.

Corporate tax comparisons

Comparisons of corporate taxes are even more complex than comparisons of individual taxes because the incentives and preferences built into corporate income tax systems have different effects, depending on the industry and the size of the enterprise under consideration. In making comparisons of taxes on corporations, it is also difficult to isolate differences in circumstances related to tax from more general differences in the business operating climate. In addition, the results will vary depending on the methodology used in making the comparison; the perspective – corporate or individual shareholder – from which the comparison is made; and whether or not payroll taxes are included in the comparison. As a result, it is difficult to reach any firm conclusion as to how taxes on corporations in Ontario compare either with those in other jurisdictions in Canada or with those in the United States.

A number of studies comparing taxes on manufacturing enterprises between Canada and the United States were reviewed by Ernst & Young for the Fair Tax Commission. These studies measured the impact of a number of business taxes (corporate income taxes, capital taxes, franchise taxes and commodity sales taxes) on specific investments in a range of industries. The tax impact included in each case the impact of tax depreciation rules, investment tax credits and export sales incentives. In each case, the position of Ontario relative to other jurisdictions varied depending on the industry studied and the taxes covered by the study. The results also depended on whether or not payroll taxes were included in the comparison.

Ernst & Young's review of these studies concluded that Ontario's corporate taxes on manufacturing industries are slightly higher than those in the United States. However, it also concluded that, "Ontario firms have significant payroll tax advantages relative to firms in Quebec or U.S. states" which could offset disadvantages in comparisons involving other taxes (Ernst & Young 1992a, 29).

A study by the Economic Council of Canada looked at the taxation of various industries in Canada and the United States from the perspective of individual shareholders. They found that, overall,

investors in Canada pay similar levels of tax to those paid by investors in the United States. For manufacturing, after-tax returns to shareholders were higher in Canada than in the United States. For other industries, after tax returns were lower in Canada (Daly, Mercier and Schweitzer 1989; cited in Ernst & Young 1992a, 35-36).

A separate study for the Fair Tax Commission by Duanjie Chen and Jack Mintz (1992) of the University of Toronto focused particularly on comparisons of the taxation of investment capital between Ontario and other provinces. Chen and Mintz conclude that investors face higher effective tax rates on capital in Ontario than elsewhere in Canada. They also find that manufacturing would be the second highest taxed industry in Ontario were it not for the special lower tax rate on manufacturing, which brings its tax rate down to the average rate for business operating in Ontario.

What do tax differences actually mean?

Although it is difficult enough to determine what the facts are in comparing taxes between Ontario and other jurisdictions, it is even more difficult to determine what such differences might mean. The most obvious problem with tax-only comparisons is that they compare taxes without reference to the benefits that the taxpayer receives from the public services paid for from the revenue raised from those taxes. In effect, these comparisons look at only one half of the bargain.

Attempting to draw a conclusion from comparisons of taxes without reference to the services that are provided from the revenue raised is like trying to decide on which car to buy from a list that includes only prices. Some of the comparisons attempt to recognize the benefits side of the equation by including estimates of the benefits from selected public services in the comparison. For example, the Price Waterhouse Canada-U.S. comparison noted the additional benefits received by Canadians from public higher education, health care and more generous public pension benefits and estimated the value of the latter two. But even where benefits are taken into account, it is normally on a partial or case by case basis.

In determining what tax differences mean, it should be noted that what decision makers perceive to be the differences between jurisdictions and how they take those perceived differences into account in their decisions may matter more than the results of an objective comparison and analysis. For example, it may be irrational to compare taxes without reference to the quality of the public services they buy, but that may well be the way people make decisions.

Do taxes affect location decisions?

For an investigation of tax fairness, the critical question posed by these comparisons of taxes is how, if at all, tax differences should temper our thinking about appropriate policy changes to make the tax system fair. To the extent that tax differences exist and act as a stimulus to migration of either individuals or corporations, these impacts may impose practical limits on Ontario's freedom to create a tax system that is different from its neighbours' or competitors', quite apart from the impact

that the distribution of tax obligations may have on the economic behaviour of taxpayers – both individuals and corporations – within Ontario.

From a theoretical perspective, economic analysis would suggest that people and investment capital that are mobile between jurisdictions would tend to be influenced in their migration decisions by differences in the relationship between taxes and benefits from government programs. Taxpayers would tend to move from jurisdictions where taxes are high relative to benefits from government programs to jurisdictions where taxes are lower relative to benefits from government programs. It should be emphasized that there is no basis in theory for a presumption that differences in taxation, by themselves, influence location decisions. The problem is, apart from taking into account obvious differences in public services such as health care and pensions, comparisons between jurisdictions do not attempt to take into account differences in public services relative to taxes.

Taxes and people

> *"...if we try to improve fairness by increasing taxes on people with high incomes, we will just drive people out of the province."*

The evidence from comparisons of taxes on individuals suggests that significant differences in tax exist at the individual level between Ontario and comparable jurisdictions in the United States. Upper-middle and higher-income individuals pay higher taxes in Ontario than in the United States. However, lower and middle-income individuals pay lower taxes in Ontario than in the United States, when differences in public spending on pensions and health care are taken into account.

Although, as indicated above, there are no data available that measure the relationship between taxes and benefits from public services at various income levels, it would be expected that beyond some undetermined threshold, significant differences in taxation could also reflect significant differences in the taxes/services relationship.

A review of studies of the impact of public policy on migration conducted for the FTC by Kathleen Day (University of Ottawa) and Stanley Winer (Carleton University) concluded that individual migration decisions tend not to be significantly influenced by differences in taxes and public services between jurisdictions. The review notes, however, that public policies in the areas typically studied are quite similar. Consequently, "the results do not rule out substantial migration responses to unusually big changes in public policies" (Day and Winer 1992, 47).

In general, studies of individual migration in response to public policy differences show that such differences represent only one of a number of factors affecting migration decisions. The impact of public policies measured by these studies tends to be small both in relation to provincial population and in relation to total flows of interprovincial migrants. Because each study focuses on the range of public policy systems existing in Canada at the time, however, the range of variation in public policies considered is relatively narrow. They are not very helpful in answering questions about the potential impact of substantial differences in taxation policies.

Taxes and corporations

> "...*higher taxes on business in Ontario would drive investment and jobs out of the province.*"

The impact of taxes on corporate decision-making is an important consideration in determining the role of corporate taxation in a fair tax system for two reasons.

First, for companies operating in more than one jurisdiction, differences in the tax treatment of corporations among jurisdictions provide an incentive for corporate tax planners to minimize the total tax liability of the corporation in all jurisdictions. To the extent that the tax laws make this possible, an attempt by one government to tax corporations more heavily than other jurisdictions tax them will be frustrated. As a result, whether or not the government wishes to tax corporations more heavily, it may not be possible without concerted international action to raise levels of corporate taxation and tighten up corporate tax administration.

Second, differences in the level of taxation among jurisdictions may be found to influence corporate decisions with respect to locating new or expanded operations. If taxes are found to be an important factor in investment and business location decisions, the impact of higher corporate taxes on economic activity will be an important balancing factor in any decision about changing corporate taxes to achieve fairness objectives.

Opinions about the impact of various elements of the tax system on business activity tend to dominate the public debate on any given tax issue. Taxes on business are inevitably subject to criticism by the businesses that pay the taxes based on assertions about their negative effect on business activity. Changes that increase taxes on business will be criticized on that basis. Any change that reduces taxes on business will be praised for its positive impact.

Looking at taxes in isolation – as a cost of doing business – it would appear obvious that, other things being equal, rational business decision makers would tend to locate their operations where taxes are the lowest. However, the problem is that other things are generally not equal, nor are they as independent of taxes as the partial analysis that generally takes place in public debates would suggest.

In evaluating the impact of tax differences, a business might consider the relationship between the tax paid and the benefits from public services, rather than considering the tax impact in isolation. For example, if taxes are used to educate and train workers, a business might decide that a better trained labour force is worth a higher tax bill.

What we know about the incidence of these taxes also weakens the argument that corporate taxes induce businesses to relocate to low tax jurisdictions. As noted in the previous discussion of the incidence of taxes, corporations ultimately do not pay taxes, people do. Market conditions determine for individual industries and firms how much of a given amount of a particular tax paid by a corporation can be passed on to consumers in the form of higher prices, passed to employees in the form of lower wages, or paid by investors in the form of lower dividends or retained earnings. To the extent that tax differences have already been taken into account for labour, capital or goods and services in local markets, they will be offset by other factors in an investment decision.

In a second study for the Fair Tax Commission, Ernst & Young (1992b) reviewed four types of studies relating to the impact of tax on business location decisions: anecdotal evidence generally related to individual location decisions; surveys of business executives; statistical analyses of the determinants of investment locations or relocations; and statistical analyses of the impact of taxes on other factors that are considered in investment location decisions.

In different ways, all of these types of studies point to the same general conclusions:

- Tax factors are likely to come into play in an investment decision after a number of candidate sites for an investment have been selected, and then only as one of a number of factors. Tax differences would have to be quite large to "get the attention" of investment decision makers at an earlier stage in the process or to play a dominant role in site selection.

- Little can be said with any certainty about the impact of taxes on such key factors as "labour supply, saving and investment behaviour, productivity and efficiency, and international portfolio behaviour" (Fortin 1989, 419).

- Studies of the influence of government spending on investment decisions do not assist in determining whether the benefits business receives from spending on infrastructure outweigh whatever business activity costs there may be from increases in taxes to fund the infrastructure investments.

In general, the studies reviewed by Ernst & Young suggest that taxes play a relatively minor role in business location decisions. However, as the Ernst & Young study points out, some additional concerns should be kept in mind when drawing conclusions from these studies.

First, any study can consider only the impact of existing differences in taxes. Since governments in North America have traditionally kept these differences small to avoid making industries in their jurisdiction "uncompetitive," no basis exists for the assessment of the potential impact of significant differences in tax treatment.

Second, these studies do not take into account that increased capital mobility as a result of recent trade agreements may have an impact on the sensitivity of investment patterns to tax factors.

Third, these studies do not and probably could not take into account the often-referred-to intangible impact of taxes on the "business climate" as perceived by decision makers.

Two things come through clearly from the existing body of knowledge about the influence of taxes on business locations. One is that no clear conclusion can be drawn from the literature concerning the degree to which taxes influence business location. The other is that the gaps in both the understanding of the factors influencing business activity and the ability of economists to measure the impact of those factors with any degree of accuracy mean that there is no definitive study possible that will answer the question.

The weight to be given these concerns in the design of a fair tax system comes down to a question of judgement about the potential impact of taxes on business decisions.

Taxes and Ontario's relationship with the federal government

> *"... Ontario can't really do very much about tax fairness because most of the major taxes are controlled by the federal government."*

The fact that Ontario exercises its taxing authority as a sub-national government within a federal structure imposes both constitutional and practical limitations on its ability to pursue tax-fairness objectives.

In the Canadian constitutional framework, authority to levy direct taxes is shared between federal and provincial governments. Authority to levy indirect taxes falls solely within the jurisdiction of the federal government. Direct taxes are defined as taxes that are actually paid by the person on whom they are levied. An income tax or retail sales tax is an example of a direct tax. Indirect taxes are taxes levied on one person but actually paid by another. A tax on the product of a manufacturer or on the sales of a wholesaler would be an indirect tax.

As the discussion of incidence in the previous section suggests, this constitutional distinction is somewhat arbitrary. Regardless of who appears to pay a tax, what matters to the taxpayer is who bears the economic burden of the tax. This is not determined by the wording of the tax statute, but by the extent to which economic factors permit the burden to be shifted to others.

For example, technically, corporate income taxes are direct taxes on corporations. In fact, the tax burden is actually distributed among consumers, workers and investors. However, as a practical matter, a substantial proportion of the revenue of both provincial and federal governments is raised from direct taxes on common tax bases. (A tax base is the amount or activity on which a tax is levied. For example, the retail sales tax base is the retail price of taxable goods and services; the personal income tax base is the total of the amounts that the income tax system recognizes as income.)

The only tax base formally shared between federal and provincial governments is the personal income tax base. However, for other tax bases such as corporate income and sales, similar tax bases are taxed at different rates by both the provincial and the federal governments. In addition, in a number of areas federal and provincial governments, exercising their constitutional powers, may levy taxes on essentially the same activity or transaction, the federal government levying an indirect tax and the provincial government levying a direct tax.

Often, administrative arrangements for actual collection make the various taxes virtually indistinguishable to the taxpayer. For example, provincial and federal excise taxes on tobacco, alcohol and gasoline are indistinguishable. They are bound up in the prices of the products, even though the federal taxes are likely technically indirect taxes and the provincial taxes are technically direct taxes.

The only major areas in which either government is the only one to impose a tax are customs duties for the federal government; and for provincial governments, property taxes and in some cases, resource royalties.

The provincial government's proportion of revenues from tax bases that are shared with the federal government varies from tax base to tax base. In 1991, the provincial government received 35% of personal income tax raised in Ontario, 32% of payroll tax revenue, 50% of sales tax revenue, and 46% of corporate income tax revenue.

This degree of shared jurisdiction has a number of important implications for a consideration of tax fairness at the provincial level.

First, there are very few tax areas in which the provincial government is able to address the full range of fairness issues of concern to Ontario taxpayers. For example, two thirds of the income tax bill will be unaffected by changes that apply only to the provincial portion of the income tax. As a result, some changes that might be contemplated to an Ontario income tax would have a negligible impact unless they are also made to the federal income tax.

Second, the terms under which tax bases may be shared between the federal government and the provinces will inevitably have an influence on a decision by Ontario to levy its own tax or to levy its tax in conjunction with the federal government.

The current income tax collection agreements allow provincial governments relatively little policy flexibility. Provincial income taxes are levied as a percentage of basic federal income tax, described as "tax on tax." This means that provincial governments are effectively required to follow the federal schedule of rates, although some provinces, including Ontario, have added new rates to the federal system by introducing low income tax relief mechanisms and surtaxes on high-income earners.

Any Ontario policy initiative in the area of income tax would have to compare the policy objectives that could be achieved in a revised income tax collection arrangement with those that could be achieved if Ontario decided to collect its income tax separately, as Quebec does. It would then have to determine whether an independent system would be worth the administrative and other associated costs.

Similarly, sales tax reform should weigh the fairness and other benefits associated with Ontario having unilateral control over the sales tax base against the potential savings associated with joint administration of the Retail Sales Tax (RST) and the federal Goods and Services Tax (GST) to which Quebec has agreed.

Third, the way that federal and provincial taxes interact with each other must also be taken into account in tax reform. For example, some taxes are deductible from income for corporate income tax purposes, others are not. A tax that is deductible for income tax purposes will have a lower impact on a taxpayer than a tax raising the same amount of money that is not deductible, because part of the cost to the taxpayer of the deductible tax is offset against income taxes.

Finally, the sharing of jurisdiction imposes practical limitations in tax design. For example, because it is so difficult to trace corporate ownership to sub-national jurisdictions, it would be very difficult for Ontario to adopt a completely different approach to the relationship between the corporate income tax and the personal income tax than that contained in the federal income tax. Similarly, to be practical, a different approach to the taxation of pension benefits in an Ontario income tax

would have to be consistent with the institutional arrangements that have been made for private pensions and tax-assisted retirement saving (Registered Retirement Savings Plans, or RRSPs).

This interaction between federal and provincial factors needs to be considered when considering fair tax reform on a provincial or federal level.

One response to these considerations might be to ignore them altogether and assume that there are no limits on provincial policy flexibility in areas of shared jurisdiction. At the opposite extreme, the commission might accept the current arrangements for tax sharing between federal and provincial governments as a given and assume that provincial policy flexibility is circumscribed by these arrangements.

However, the commission believes that neither of these extreme views is appropriate or realistic. On one hand, the commission must fulfill its mandate to study fair tax reform from a provincial perspective. On the other hand, if the commission were to limit its review to those options that are possible under existing federal-provincial arrangements, it would be ignoring reform options that would be possible if these arrangements were amended or abandoned.

For tax bases in which federal-provincial considerations are a factor, an analysis in three stages is required. First, the major opportunities for fair tax reform must be identified and developed. Second, limitations that would apply even if Ontario were to exercise its full legal authority to proceed independently must be taken into account in developing realistic goals for provincial taxation policy reform. Third, those goals must be examined to identify changes that could be achieved within an amended federal-provincial tax collection agreement.

This analysis will generate three types of recommendations:

- Recommendations for fair tax reform that would be possible only if implemented at both the federal and provincial levels.
- Recommendations that could be implemented at the provincial level if Ontario exercised its independent authority.
- Recommendations that could be implemented in a renegotiated federal-provincial agreement.

Only when the analysis has been completed and the recommended goals for reform developed, can the fundamental judgement be made as to which taxes should be levied independently by Ontario and which taxes should be levied through federal-provincial arrangements.

With respect to sales taxes, the federal government has been attempting to negotiate joint collection and administration agreements with provincial governments for provincial retail sales taxes and the GST. To date, different agreements have been negotiated with Prince Edward Island and Quebec.

With respect to income tax, some people think that Ontario should levy its own personal income tax rather than piggybacking on the federal tax. They argue that this is necessary to enable Ontario to pursue its own policy objectives both in tax fairness

and in other policy areas. For example, it is often argued that Ontario could better integrate tax and social assistance policies in its own income tax.

Others worry about complexity and the increased administrative cost that would be incurred in a separate Ontario personal income tax.

Discussions between federal and provincial governments on these issues are ongoing. The most recent public development has been the release of a discussion paper by the federal government that outlines a new model for income tax integration (Personal Income Tax Coordination 1991).

The arrangements discussed in the federal paper would permit provinces to adopt their own income tax rate schedules. Provincial tax would be based on federally defined taxable income ("tax on taxable income") rather than on the federal tax payable. Federal definitions would continue to apply to the tax credits currently provided for in the federal income tax, but provinces would be permitted to vary the amounts of those credits.

In its review of the federal discussion paper, the FTC concluded that the increased flexibility offered in the paper does not dramatically increase provincial policy flexibility and fails to address many of the fundamental issues in current federal-provincial finance (Fair Tax Commission 1991).

The FTC position paper noted, for example, that the system described in the federal paper would not permit provincial governments to address inequities in the treatment of low-income taxpayers by integrating the provincial tax and social assistance transfer systems. The FTC recommended instead that:

- A formal process should be developed involving provincial governments in decisions affecting the common elements of the personal income tax system, reflecting the fact that the personal income tax is the largest provincial revenue source.
- Federal-provincial agreements should make explicit provision for the taxation of provincial incentives and subsidies and the tax deductibility of provincial taxes.
- Federal-provincial agreements should make explicit provision for audit coverage of provincial elements of the income tax system.
- Future agreements should clearly spell out which provincial measures qualify for federal administration and which do not, in order to ensure consistency in their application.
- Whatever arrangements are made regarding tax collection, the goal of making it clearer to the taxpayer which level of government is collecting taxes and providing credits can and should be achieved, even in the current system, through a redesign of forms and guides and other administrative changes.

With respect to the issue of Ontario levying its own separate personal income tax, the commission concluded:

> The commission's position on the question of a separate Ontario personal income tax at the conclusion of its work will depend on a number of factors including: the eventual content of any federal-provincial income tax co-ordination agreement; other federal-provincial financial and constitutional developments; and its assessment of the costs and benefits of departing from that structure to achieve specific tax goals; an assessment of the policy flexibility which might be available without the constraints of a federal provincial collection agreement, recognizing the external constraints imposed by the need for some degree of conformity among neighbouring jurisdictions; and a consideration of the net financial costs and policy benefits of departing from the current structure (Fair Tax Commission 1991, 13).

More recent research for the commission has estimated the incremental costs to taxpayers, employers and financial institutions of compliance with an Ontario personal income tax similar in structure and complexity to the current Quebec system. Ongoing costs are estimated at $373 million, and start up costs at $277 million (Erard and Vaillancourt 1992, 28).

As noted above, the benefits associated with greater policy control over a major revenue source must be weighed against the costs.

How different can Ontario's tax system be?

> *"... even if Ontario had the power to run its own tax system, it couldn't do very much that is different from other provinces because of the economic effects of trying to be different from our neighbours."*

Together, the various limiting factors described above form the basis for an answer to the fundamental question of how different Ontario's tax system can be, compared with those of its neighbours or competitors. There is no technical answer to this question. In the end, it will be a matter of judgement. Nor is there a single answer to that question for all taxes and all potential policy options. However, it is a question that must be addressed and considered carefully since neither of the simplistic answers is viable.

One extreme response to the tax competitiveness issue would require that Ontario establish, tax-for-tax, rates of tax that match the lowest rates applicable in U.S. jurisdictions with which Ontario competes. Because this approach ignores completely the different sizes of the public sector between Ontario and its U.S. counterparts and the cost of the social benefits Ontarians enjoy, it would leave the province unable to pay for the public services it currently provides.

At the opposite extreme, a response that suggests there are no restrictions on Ontario's ability to pursue a different course flies in the face of economic reality. One may not like the fact that the mobility of capital and labour between jurisdictions imposes economic limits on tax policy flexibility, but it is a fact that cannot be ignored.

V. Confronting the Issues – Fairness in Individual Taxes

In developing recommendations for tax reform regarding particular taxes, the commission will address two issues: changes that are required to make a particular tax fairer; and changes in the weight that should be given to each tax in the tax mix to improve the fairness of the tax system as a whole.

The fairness of a particular tax can be improved by changing the way it is designed. For example, the income tax can be changed to treat taxpayers in equivalent economic circumstances more consistently; it can be made more or less progressive by changing the rate structure.

The mix of taxes matters because different taxes bear different relationships to the taxpayer's ability to pay. As a result, the relationship between the total of all taxes and a taxpayer's ability to pay can be changed by reducing some taxes and increasing others. For example, the tax system as a whole can be made more progressive by increasing the amount of tax raised from progressive taxes and reducing the amount raised from regressive taxes. The system can be made more regressive by increasing the relative weight of regressive taxes in the tax system.

For most taxes, changes aimed at improving the fairness of a particular tax and changes in tax mix are independent of each other. The fairness of the level of the particular tax can only be determined in the context of the levels of other taxes in the system. Therefore, for the particular taxes for which ability to pay is the appropriate fairness criterion, the question of tax level will not be addressed in the following discussion.

However, for benefits taxes, the tax level can be considered "too high" or "too low" depending on its relationship to the value of the benefits received by the taxpayer. Because the tax is essentially a price, to determine whether a benefits tax is fair or not, we have to look both at its structure and its level in relation to the value of the benefits it delivers to the taxpayer.

Property tax

Property tax in general and its use for the funding of education in particular have been the most frequently raised issues in the Fair Tax Commission's consultative work to date. The commission has received hundreds of letters from the public concerning property tax and local government finance. The commission's tax forces have also identified these issues as important tax fairness issues in their communities. Members of the commission and staff have met with dozens of groups across Ontario concerning property tax and education finance issues.

The issues include the operation of the assessment system and the problems associated with using market value as a basis for property assessment; the funding of social assistance from property taxes; the system of financing education with its heavy reliance on local property taxes; and the property taxation of businesses.

Cottagers and seniors have argued they should not be required to pay property taxes to support local education costs. Small business owners in the downtown areas of large cities have argued that market value assessment forces them to pay more than their fair share of local taxes. Small business tenants in shopping malls have complained that they pay a disproportionate share of the property tax compared with the major supermarket and department store tenants. Tenants make the point that they are overtaxed compared with homeowners.

This section highlights the research and analysis done for the Property Tax Working Group and some of the main conclusions reached by the group, and attempts to place the issues raised in the commission's consultation in the context of those results (Fair Tax Commission 1992c).

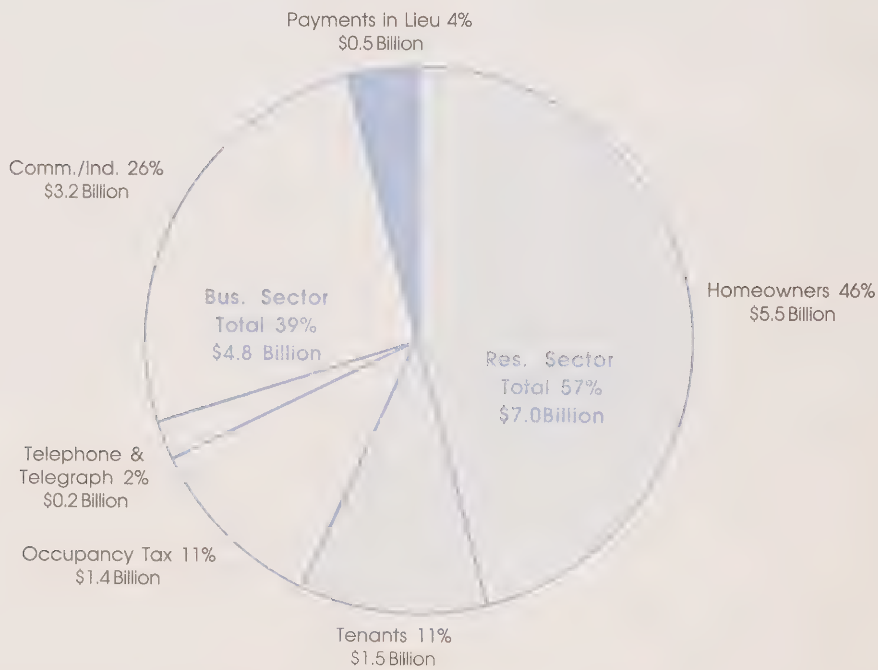
Who pays property taxes?

The property tax is, in fact, two taxes: a tax on residential property, which applies to owner-occupied and rental property; and a tax on non-residential property, which applies to commercial and industrial property.

The residential property tax is paid directly by owner-occupiers and indirectly by tenants through their rent.

In 1992, the residential property tax was expected to raise approximately $8.1 billion, making it the second largest tax

FIGURE 14
WHO PAYS THE PROPERTY TAX IN ONTARIO, 1990



Source: Ministry of Municipal Affairs, Municipal Analysis and Retrieval System (MARS).

paid by individuals in Ontario after the personal income tax ($13.9 billion, 1992-93 projected), and ahead of the provincial sales tax ($7.9 billion, 1992-93 projected). (Estimates provided by Municipal Finance Branch, Ministry of Municipal Affairs).

Local taxes on non-residential property include the commercial and industrial property tax, which is paid by the owner of the property, and the business occupancy tax, which is levied as a percentage of the commercial and industrial property tax on the business property, but is paid by the business occupant of the property.

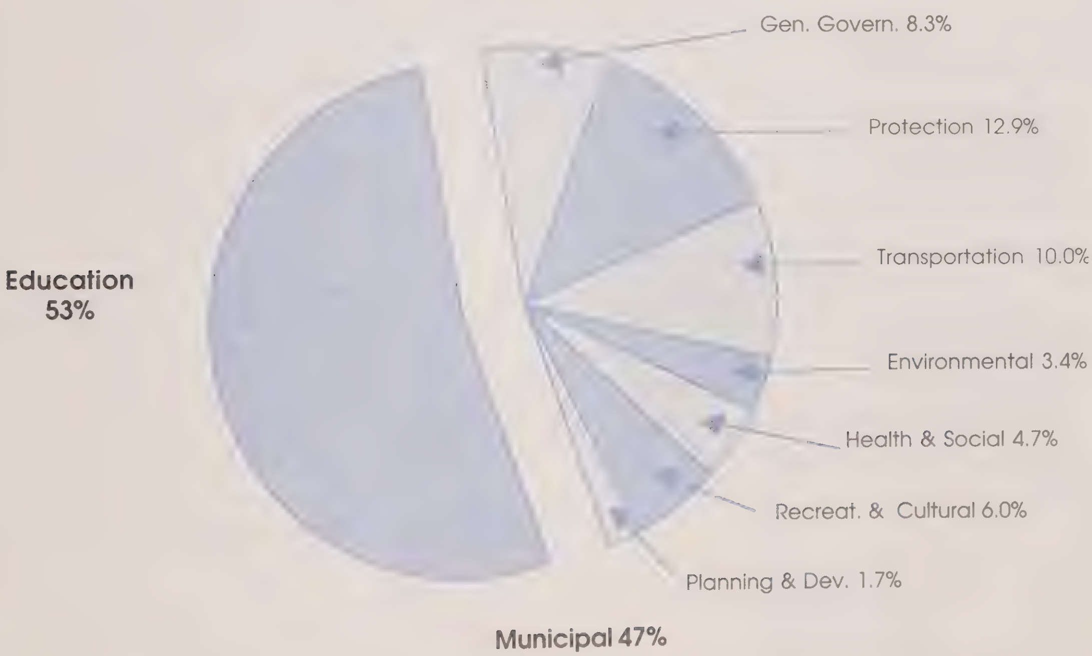
These taxes on business combined are expected to generate total revenue of $5.7 billion in 1992, compared with an estimated provincial total of $3.3 billion from Ontario's corporate income and capital taxes in the fiscal year 1992-93. In 1990, the most recent year for which comprehensive figures are available, the residential sector accounted for 57% of total property tax revenue. The business sector accounted for 39%. Payments in lieu of property taxes by the federal and provincial governments accounted for the remaining 4% (Ontario *Budget* 1992, and Ministry of Municipal Affairs).

What does the property tax pay for?

> *"... it's not fair that my property taxes keep going up to pay for education. Education doesn't have anything to do with owning property."*

It is well known that residential and business property taxes are the major source of funding for local government in Ontario. What is not as well known is

FIGURE 15
USES OF PROPERTY TAX IN ONTARIO, 1990



Source: Ministry of Municipal Affairs, Municipal Analysis and Retrieval System (MARS).

that the property tax in the 1990s is more an education tax than it is a municipal tax. In the past decade, the allocation of property tax revenue between school boards and municipal governments has shifted to the point where the financing of education accounts for a higher proportion of local expenditure from property taxes than the financing of municipal government.

Figure 15 shows how property tax revenues were divided between school boards and municipalities, and among various categories of municipal spending in 1990. Approximately 53% of property tax revenues went to education. After allowing for provincial grants for particular municipal functions and program-specific user charges, the next largest uses of property taxes were for police and fire services at 12.9%, called protection in the chart, and transportation at 10%. Health and social services combined were responsible for 4.7% of the property tax bill.

In addition, a review of the finances of school boards and municipal governments reveals that school boards are more heavily dependent on property taxes for their revenue than are municipalities. Property taxes accounted for approximately 55% of the funding for school boards in Ontario in 1990, but only 38% of the funding for municipal government. In 1992, it is estimated that property taxes will account for as much as 60% of local education revenues (Ministry of Municipal Affairs).

The residential property tax and ability to pay

> *"... the property tax is regressive, but so are a lot of other taxes."*

Research conducted for the FTC Working Group on Property Tax confirms the traditional finding that the property tax is a regressive tax – the proportion of household income devoted to residential property taxes decreases as income increases. On average, property taxes are a greater relative burden for low-income households than for higher-income households. This result confirms what virtually every study of the property tax has found (Fair Tax Commission 1992c, 13).

Figure 16 illustrates the results of one of these studies on the relationship between property taxes and ability to pay as measured by household income.

The middle line in the chart (shown on the legend as the median) shows the average impact of residential property taxes on household incomes within each income range. Property taxes are regressive – they decline as a percentage of household income as income increases

The other lines on figure 16 document the wide variation in household income impacts of residential property taxes. Within each income range, the relationship between household income and property tax varies a great deal. Of households in each income range, 25% pay a higher percentage of their income on property tax than the percentage shown by the top line (shown on the legend as the 75th percentile) on the chart. In each income range, 25% of households pay a lower percentage than the percentage shown by the bottom line on the chart.

For example, in the $40-50,000 household income range (close to an estimated 1991 provincial average household income of $52,250; FTC estimate based on Statistics Canada Social Policy Simulation Database and Model) the average household paid just under 4% of its income on property tax. However, 25% of households paid out more than 4.9% of their incomes in property tax; 25% of households paid out less than 2.25% of their incomes in property tax.

On average, property tax is regressive in relation to household income. However, the impact varies so dramatically within income ranges that at the individual household level, the relationship between property tax and household income is nearly random.

These findings are confirmed in a special study that looks at the relationship between various property and household characteristics and household incomes at the community level (Bossons 1993). Preliminary results of this study for the Town of Pickering and the City of Etobicoke show that there is virtually no relationship between household income and the market value assessment of the residential property occupied by the household. These results also show weak relationships between various physical characteristics of the property and household income.

For example, for the Town of Pickering, only 3% of the variation in market value assessment is related to differences in household incomes. For the City of Etobicoke, the relationship was somewhat stronger, but still extremely weak. In Etobicoke, only about 7.5% of the variation in market value assessment is related to variations in household income.

FIGURE 16
RESIDENTIAL PROPERTY TAX AND INCOME:
PROPERTY TAX IMPACT AS A PERCENTAGE OF INCOME BY RANGES OF HOUSEHOLD INCOME, ALL ONTARIO RESIDENTS, 1991

Source: FTC special tabulation using Statistics Canada, Social Policy Simulation Database and Model (SPSD/M).

A property tax based on market value assessment would appear to bear no systematic relationship to ability to pay.

This phenomenon is not, however, unique to market value as an assessment base. Other characteristics of property such as the floor area of the dwelling appear to be as unrelated to ability to pay as the assessed market value.

Statistically, although neither relationship is very strong, a poll tax (a tax levied as a fixed number of dollars per adult resident) is about as strongly related to ability to pay as the property tax.

The residential property tax as a wealth tax

It is often contended that, while the property tax may not be very closely related to income, it is justified on the basis that it taxes a form of wealth and thus is related to another measure of ability to pay. The argument is that because other forms of wealth are not taxed, the property tax is to some extent offsetting a gap in the tax system (Kitchen 1987).

This argument, however, is open to question on a number of grounds. First, even assuming that wealth held in the form of residential property is a reasonable base for a wealth tax, the property tax base is not appropriately defined. The assessment of residential property for property tax purposes is based on the estimated value of the property taking no account of the debt associated with the property, whereas the appropriate base for a wealth tax would be the net value of property after deducting mortgage and other debt associated with the property.

Second, because the property tax is a tax on only one component of wealth, it would be a reasonable substitute for a wealth tax only if all households held roughly the same proportion of their net

FIGURE 17
RESIDENTIAL PROPERTY AND WEALTH:
PROPERTY VALUE AS A PERCENTAGE OF NET WEALTH, BY RANGES OF HOUSEHOLD INCOME IN ONTARIO, 1989

Source: FTC calculations based on Ernst & Young 1990, *The Wealth Report*.

wealth in the form of residential property. In fact, the proportion of household wealth held in the form of residential property varies, depending on the income and wealth of the household.

An analysis of household wealth based on Ernst and Young's *The Wealth Report* (1990) shows that the higher the income of a household, the lower the value of residential property as a percentage of its wealth. Figure 17 illustrates the pattern of wealth holdings found in this study. It shows that, in 1989, the value of the residential property occupied by a household declined as a percentage of the household's net wealth as income increased. In other words, the higher a household's income, the less important the home is as a proportion of the household's net wealth.

These data also suggest, and other 1984 data from Statistics Canada confirm (Statistics Canada 1986), that residential property makes up a much larger share of the net wealth of average households than it does of the net wealth of wealthy households.

Because residential property is the primary component of the wealth of households with low and moderate incomes and with relatively low levels of wealth, the property tax as a wealth tax is an extremely regressive tax.

Property taxes on business

"... property taxes are a major reason why so many companies are moving south."

Property taxes on businesses in 1992 raised a total of $5.7 billion. Measured in terms of the total dollars raised, the non-residential property tax is by far the most important tax imposed on business under provincial jurisdiction. Despite this fact, there has been a surprising lack of study of its impact on industry.

Because they are linked to a fixed cost of doing business, property taxes on a business are not well related – at least in the short term – to the level of activity in the business. Payroll taxes, because they vary with the level of employment, are better related to business activity. Corporate income taxes have the further advantage from the perspective of the business taxpayer of being related directly to the success of the business, as measured by its profitability.

Two questions arise: First, would a change in the mix of local taxes on business attract more business investment to Ontario, create jobs and increase workers' incomes? Second, would such a change increase or decrease the overall fairness of the tax system?

Other taxes on business property

In addition to the commercial and industrial property tax levied on property owners by local government, two other taxes based on property also affect business in Ontario.

The business occupancy tax is a local tax based on property assessment but paid by the business operator rather than the owner of the property. In 1992, it raised approximately $1.7 billion of the nearly $14 billion currently raised by local taxes on property (estimates provided by Municipal Finance Branch, Ministry of Municipal Affairs). Different rates of tax apply to different classes of business. These rates

range from 25% of the property tax on land occupied or used as a commercial parking lot to 75% of the property tax on land occupied or used by a distiller or brewer. The business occupancy tax applied to most small businesses is 30% of the property tax on the property.

The Property Tax Working Group found that there is no rational basis for the current schedule of rates and identified major problems faced by municipal governments in collecting the business occupancy tax. It recommended that an alternative should be found to replace this tax.

The Commercial Concentration Tax is a provincial tax of a flat per-square-foot amount on commercial parking lots and a flat per-square-foot amount on the portion of a commercial property that exceeds 200,000 square feet. It is levied only on property located in the Greater Toronto Area (the regions of Peel, Halton, York and Durham and Metropolitan Toronto). Its stated purpose, when it was introduced, was to provide funding for major roads and transit facilities in the Toronto area.

The Property Tax Working Group criticized the tax as arbitrary and as an unwarranted incursion by the provincial government into the local property tax field. The working group also questioned the fact that the Toronto area is singled out for special taxation to support transportation facilities while other areas of the province have such facilities funded from provincial general revenues.

The working group recommended that the Commercial Concentration Tax be abolished.

What services should be funded from property taxes?

It is apparent from the research undertaken for the commission and for the Property Tax Working Group that the residential property tax is not well related to the ability to pay of those who bear the burden of the tax.

That conclusion has important implications both for the kinds of services that should be funded from property taxes and the design of the system for property assessment.

The Property Tax Working Group considered the fairness of the municipal and education finance system in relation to the appropriateness of the revenue source to the service being funded. From that analysis, the working group concluded that services currently funded by local government should be divided into three broad categories:

- Services for which fairness suggests the cost should be distributed on the basis of ability to pay.
- Services for which fairness suggests the cost should be distributed among the users, based on their share of total consumption of the service.
- Remaining services for which fairness suggests that the cost should be distributed on the basis of property assessment through a property tax.

Based on this approach to fairness, the working group reached the following conclusions:

- Where feasible, services having income redistribution as a direct or indirect objective, or generating spillover benefits beyond local boundaries, should be funded from taxes based on ability to pay.

- These services should include education, social assistance (welfare); and alternative-to-market services which are provided on a subsidized basis, such as child care and homes for the aged.

In effect, the working group concluded that it is not fair for services such as education to be funded from a tax that is as unrelated to ability to pay as the residential property tax. It recommended that, to the extent feasible, funding for education and other public services should be shifted away from the residential property tax.

Measured by its impact on property taxes, education is the most important of the services whose funding from property taxes would be considered to be inappropriate by the working group.

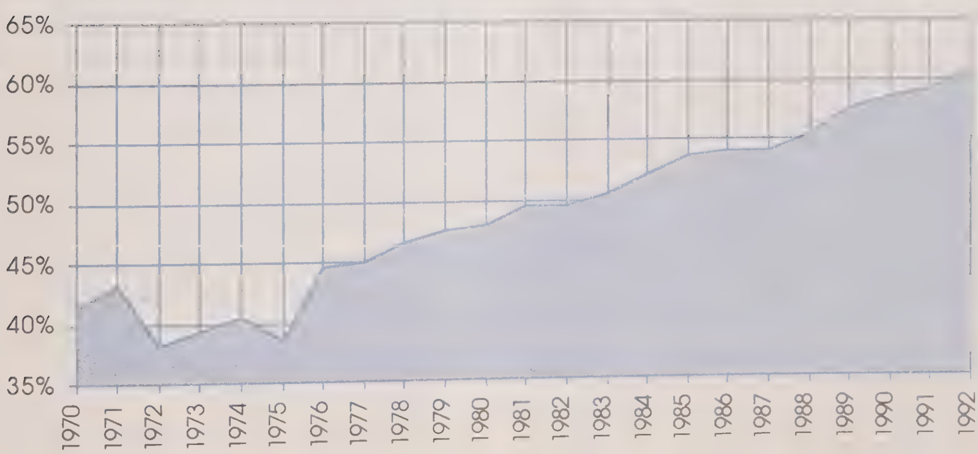
Fairness in education funding

"... I really resent the way education taxes have continued to go up."

Since the mid-1970s, Ontario has become more dependent on local property taxes for education funding. Figure 18 shows that Ontario's dependence on property tax for the funding of education has grown from just over 40% in 1974 to an estimate of more than 60% in 1992. Ontario is far more dependent on property taxes than any other province in Canada. Most of those provinces that do rely heavily on property taxes for education funding tend to raise at least a portion of the funding from property taxes that are province-wide and uniform rather than locally determined.

Heavy reliance on a funding source that is regressive and unrelated to ability to pay is not the only problem with the system for

FIGURE 18
EDUCATION FUNDING - ONTARIO'S GROWING PROPERTY TAX DEPENDENCE:
PERCENTAGE OF ELEMENTARY AND SECONDARY EDUCATION COSTS FUNDED FROM PROPERTY TAXES, ONTARIO, 1970-1992



Source: Ministry of Education, Administrative Data; and Ministry of Municipal Affairs.

funding of education. FTC research raises serious questions about the adequacy of the current system for allocating provincial grants for education, given its objectives of enhancing equity for both students and taxpayers.

First, the amount of spending that is recognized by the provincial government for grants purposes is unrealistic. In 1990, the spending level recognized by the provincial government in its grants formula averaged $4000 per student. The average amount actually spent by local school boards was nearly $6500.

Second, the recognized spending amount varies little on a per student basis across Ontario. It does not fully account for differences in local costs or for differences in the characteristics of student populations served by boards. Reflecting in part the diversity among the student populations served by boards in different parts of the province, total spending per student is anything but uniform. Data generated for the Property Tax Working Group show that net operating spending per student in 1990 was $6467 on average for the 122 major school boards. The largest of these boards, which serve the vast majority of the students in Ontario, showed per-pupil spending levels within 10% above or below the average. However, many of the smaller boards in Ontario experienced substantially lower per-pupil spending levels. Spending in the 122 major school boards ranged from as low as $4000, to as high as $10,000 per student (Ministry of Education, Administrative Data, cited in Fair Tax Commission 1992c, 93).

Third, the grants system fails to achieve its goal of fairness for the taxpayer. The taxpayer equalization component of the grants formula is based on assessment. Given the conclusion from FTC research that assessment bears very little relationship to ability to pay, it is not surprising that the working group found that grants allocated on the basis of assessment do not correct the differences in the impact on household incomes of the education portion of residential property taxes.

Using assessment as an indicator of ability to pay at the community level does not work. Despite the expenditure by the province in 1992 of nearly $5 billion in grants intended to equalize tax impacts across the province resulting from education spending, the impact of residential property taxes for education on household incomes is random, varying substantially from community to community.

In 1990, average residential property taxes for education were 1.8% of household income in Ontario. However, there were wide variations in impact around this average. In many boards, the household income impact of education property taxes was 1.2% or less; in others the household income impact was well above 2%. Even when we look only at residential taxes for the portion of education spending that is recognized by the provincial government, wide variations exist. While the average impact was 1% of household income, there were many boards in which the household income impact was less than 0.8% or more than 1.5%.

In addition to the fairness issues raised by the relationship between education property taxes and ability to pay, the working group addressed the question of exempting some categories of property taxpayers from the payment of education property taxes.

Many cottagers and seniors have taken the position that people who do not have children in the school system should not have to pay

education property taxes. The working group was not able to accept the idea behind the proposal that education property taxes should be seen as a type of user fee from which non-users should be exempt. It concluded that the property tax should be seen as the principal source of general revenue to support local services and that taxpayers should not be exempted from paying for particular services that are funded from property taxes.

The working group agreed that the funding of education from property taxes was not fair, but argued that the solution was not to exempt particular taxpayers from the tax, but to reform the system as a whole for the benefit of all taxpayers.

It recommended that to the extent feasible, education should not be funded from the property tax but should be supported from provincial revenue sources better related to ability to pay. To the extent that property taxes continue to be required to pay for provincially recognized spending, the working group recommended that provincial grants be re-allocated to ensure consistent taxation of commercial and industrial property across the province and to ensure that residential property taxes for recognized education spending have the same impact on household incomes in the community for every school board.

The working group also made recommendations concerning the expenditure side of education funding. It concluded that the level of expenditures per student that is recognized for provincial funding support is inadequate given provincial educational objectives, and that the funding formula should be made much more sensitive to differences in demographic characteristics of students and communities as well as differences in costs at the local level.

For expenditures above the level recognized by the provincial government, the working group recommended that local boards continue to have the ability to raise whatever funds were approved locally to support locally mandated programs. However, a minority report argued that the current system discriminates against boards with relatively small property assessment bases on which to levy taxes for locally determined programs and recommended that equity for students would be best served by pooling commercial and industrial assessment across the province. Boards would continue to be able to raise revenue locally from their residential assessment base only.

One difficult consideration in education finance reform is the potential impact of greater provincial involvement in funding on the structures for local governance in education. Specifically, the question arises: Can there be meaningful local governance in education in Ontario if only a small proportion of the cost of education is raised from local revenue sources for which local school trustees are responsible?

Appropriate revenue sources

The Fair Tax Commission is considering alternative models for funding local government and the services currently funded from property taxes. Its investigation will be based on identifying sources of revenue appropriate to services, and services appropriately funded from general taxes on property.

The goal is to identify which services should be funded from user charges, either wholly or in part; from taxes based on property; and from other revenue sources, either local or provincial.

With respect to the funding of municipal general welfare assistance, the provincial government and the Association of Municipalities of Ontario came to an agreement in January 1993 that will see the provincial government assume full responsibility for funding general welfare assistance allowances. With respect to education, one option might be to fund the physical plant operations of the education system from local property taxes – the schools, playgrounds and so on – and the educational services from taxes related to ability to pay.

The configuration of services that the commission concludes should be funded from property taxes will have a significant influence on the design of the property tax base as well as on the range of alternative revenue sources that should be made available to local governments.

How fair is the current assessment system?

> *"... it's not fair that tenants pay a higher rate of property tax than homeowners."*

Because rental residential property is taxed more heavily than single-family residential property, tenants pay higher property taxes than homeowners. These differences are not apparent because they are hidden in the assessment system.

Ontario's property assessment system is a system in name only. In theory, there is a single standard – market value – for property assessment. In practice, the same types of property are assessed differently – at dramatically different proportions of their market value – in different parts of Ontario.

For example, in a sample of 31 larger municipalities selected for study by the working group, the assessment of single-family residential property in Ontario ranged from a low of 1.5% of estimated 1990 market value in Toronto to 9% in Sault Ste. Marie to a high of 41.5% of estimated 1990 market value in Barrie.

This makes it very difficult for taxpayers to compare taxes in different parts of Ontario. From one community to another, different types of property are assessed differently in relation to each other.

For example, in Brampton, high-rise residential property is assessed at a rate which is more than 50% higher (at 19.8% of value) than single-family residential property (at 12.2% of value). Commercial property in Brampton is assessed at approximately the same rate (at 10.2% of value) as single-family residential property. In Etobicoke, high-rise residential is assessed at nearly four times the rate for single-family residential property. Commercial property is assessed at roughly double the rate for single-family residential property.

Residential property taxes are substantially higher in Peel and York Regions than in Metropolitan Toronto. One of the reasons for this is that commercial and industrial property owners pay lower taxes relative to residential property owners in Peel and York than in Metropolitan Toronto. Regional taxes on residential property are higher to support these regions' lower taxes on commercial and industrial property. Peel and York have effectively been subsidizing commercial and industrial development through lower property taxes. The cost of this implicit policy is paid for with higher effective rates of tax on residential property.

In theory, all residential property is supposed to be taxed uniformly at 85% of the rate of tax on commercial property, and industrial property is supposed to be taxed at the same rate as commercial property (an industrial tax rate that is 100% of the tax rate on commercial property). That is what the legislation requires.

The data present a very different picture. In practice, rates of tax adjusted to a common market-value base vary widely in relation to each other at the local level because local assessment systems differ.

The assessment system in Ontario recognizes four principal property classes: residential with fewer than seven units; residential with seven or more units; commercial; and industrial.

The working group's analysis revealed that, in general, rental residential property is the most heavily taxed of the four main property categories. Industrial property is the next most heavily taxed property type, followed by commercial property. Owner-occupied single family residential property is taxed at the lowest effective rate.

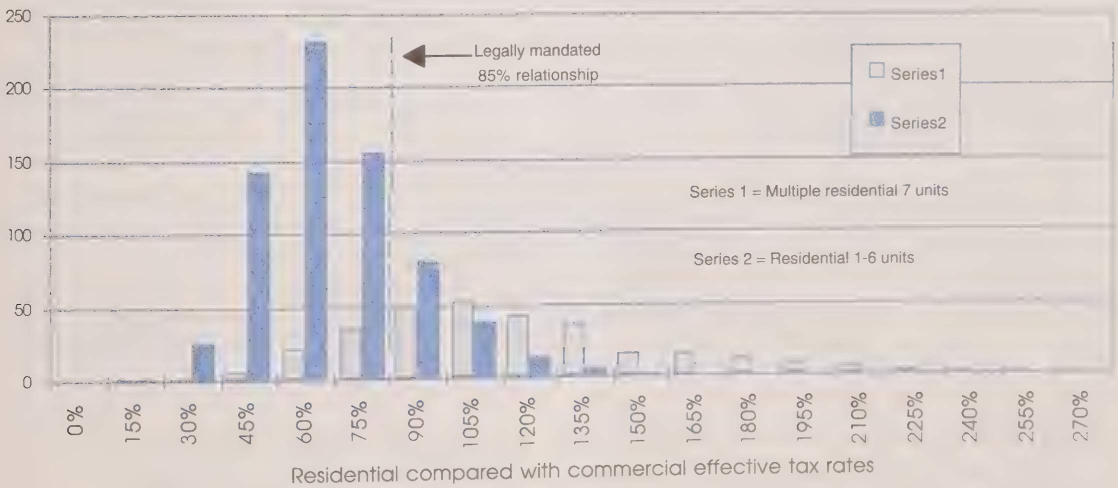
Both the general patterns and the variations in those patterns are illustrated in the following figures. They show the rates of tax on each class of property compared to the rate of tax on commercial property when each tax rate is measured in relation to a common basis for assessment.

Figure 19 focuses on the effective tax rate for residential property with six or fewer units and seven or more units, as compared with the effective tax rate for commercial property. It shows, for example, that in approximately 230 municipalities in Ontario, residential properties in buildings with six or fewer units are taxed at 60% of the rate for commercial property. In approximately 25 municipalities, the

FIGURE 19

RESIDENTIAL AND COMMERCIAL PROPERTY TAX RATES:

DISTRIBUTION OF EFFECTIVE TAX RATES ON RESIDENTIAL PROPERTY COMPARED WITH COMMERCIAL TAX RATES, ONTARIO, 1990



Source: Ministry of Municipal Affairs, Municipal Analysis and Retrieval System (MARS).

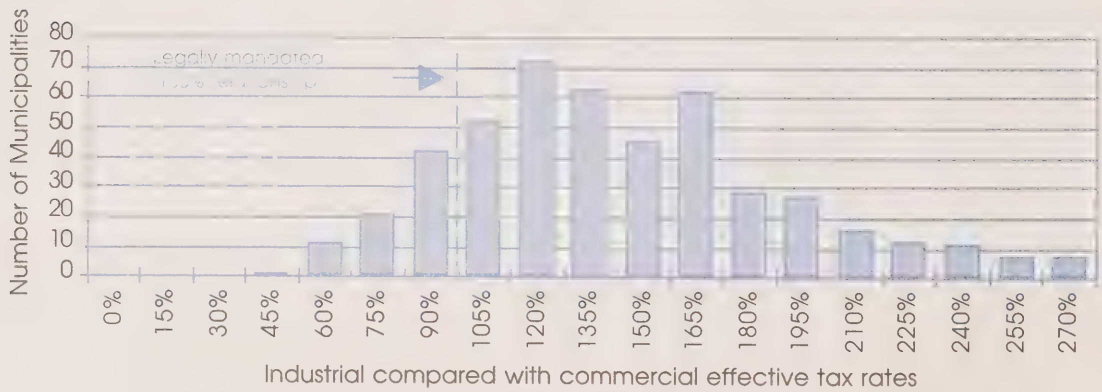
residential tax rate is 30% of the commercial tax rate. What is noteworthy is that these wide variations in the relationship between the tax rate on small residential buildings and the tax rate on commercial property persist in a system in which there is a legally mandated fixed relationship – 85% – between these two tax rates.

The pattern for larger multiple residences (seven or more units) is quite different. Whereas for residential properties with six or fewer units, most municipalities imposed taxes at lower effective rates in relation to commercial property than the legally mandated 85%, for larger multiple residences, the effective tax rates were typically much higher than 85% of the commercial rates.

None of these differences is visible. The rates of tax on these various types of property appear to bear exactly the relationship to each other that is mandated by law. The differences are created by variations in assessment policies and practices hidden from view in the assessments of individual properties.

In figure 20, the effective tax rate on industrial property is compared with the effective tax rate on commercial property at the local level across Ontario. The data show that, despite the fact that the tax rates are supposed to be the same, industrial property is taxed relatively more heavily than commercial property in most Ontario municipalities.

FIGURE 20
INDUSTRIAL AND COMMERCIAL PROPERTY TAX RATES:
DISTRIBUTION OF EFFECTIVE TAX RATES ON INDUSTRIAL PROPERTY COMPARED WITH COMMERCIAL TAX RATES, ONTARIO, 1990



Source: Ministry of Municipal Affairs, Municipal Analysis and Retrieval System (MARS).

Market value as an option

> *"... it's not fair that my property taxes go up under market value assessment just because it's located on land that could be redeveloped."*

Although it has not been followed to any conclusion, the provincial government's goal for more than 20 years has been to develop a single system of assessment for all property in Ontario based on the market value of the property, and eventually to have all property within the same municipality assessed on the same basis with residential tax rates at 85% of commercial and industrial tax rates.

The research and analysis done by the Fair Tax Commission for the working group raises serious questions about the appropriateness of this goal. It is clear that the residential property tax and the commercial and industrial property tax have quite different impacts. There is no reason in principle why the assessment base should be the same for each, nor is there any reason in particular why the rate of tax should be the same.

Furthermore, the traditional argument made for market value as an inherently superior system for residential assessment – that it links property taxes to the ability to pay of the occupants of the property – is not borne out by the FTC analyses of data describing the impact of the tax.

In addition, the introduction of region wide market value assessment in Ottawa and proposals to introduce market value assessment in dynamic and diverse property markets such as Toronto, Halton and Hamilton have underlined both conceptual and practical problems with the market value model for assessment reform.

Although market value sounds simple as a concept, it is very difficult to estimate on a consistent basis. Different methods for estimating market value produce different results because they are measuring different things. Some methods measure the value of the redevelopment potential of a property, others do not.

Strip retail business property is assessed on the basis of arm's-length sales of similar properties, a valuation method that includes in the result the value placed by the market on the potential for future gain on the property. Large commercial properties and shopping centres are assessed based on the rental income of the property, a method that does not incorporate future redevelopment or capital gain potential.

As a result, some properties are assessed based on their value in their current use; others are assessed based on the value of a potential future use.

Alternatives to market value assessment

While some of the negative impacts of a market value-based property tax can be reduced by reducing the extent to which government relies on the tax, it will likely remain the largest single source of tax revenues for local governments.

An analysis of the services that might appropriately be funded from property taxes is crucial to developing alternatives to market value for consideration as potential assessment bases.

Services such as police and fire protection provide benefits for current users of properties. The nature of such benefits suggests that if value is used as the basis for property

tax assessment, the value to be used should perhaps be the value of the property in its current use rather than speculative market values.

In addition, the Property Tax Working Group recommended that the commission study an alternative using physical characteristics of properties as the basis for assessment. In its simplest form for residential properties, this alternative would base property taxes on the square footage of housing units (or possibly on some combination of house size and lot area). This alternative might be simple and easy to understand and administer, but might not adequately reflect variations from area to area in benefits received by households from municipal services.

One option might be to base the residential property tax on values of properties in their current uses, but to implement such an assessment base by applying area-wide average rental values per square foot to the measured area of housing units of different types. Such an option would mean that the property tax would reflect rental value, but without requiring subjective (and expensive) assessments of value for each individual property. Appeals for individual properties would be easier and based on objectively determined measurements.

Non-residential property taxes might also be based on average rental values of similar properties. This alternative would have to include special provisions for how vacant property should be taxed, and would have to deal with the special problems that arise for unique properties such as large industrial plants.

Obstacles to reform

One of the factors that makes local government finance reform so difficult is that the logic of tax fairness very quickly runs up against the fact that the tax raises a very large amount of revenue for government in Ontario.

Any substantial reduction in the role of property tax in education funding implies increases in other taxes to make up the revenue shortfall. The following calculations of the impact of such a reduction are based on the 1992-93 Ontario Budget, and on data from the Ontario Ministry of Education and the Ontario Ministry of Municipal Affairs.

Removing educational services from the property tax, leaving only physical plant operations to be funded from property taxes, would remove all but 20% of education costs from the property tax.

Based on estimates for 1992 of local education spending and property taxes, removing all but 20% of education costs from the property tax would reduce property taxes by about 40%, or $5.3 billion. Assuming that the distribution of taxes between the personal (residential) and business (non-residential) sectors remained the same, removing education funding from the property tax base would require $3.1 billion in residential property taxes to be shifted to other personal tax sources and $2.2 billion in commercial and industrial property taxes and business taxes to be shifted to other business tax sources.

If the full $3.1 billion in residential taxes were shifted to the personal income tax, personal income tax revenue would have to be increased by nearly 22%, and would require an increase in the income tax rate from 55%

of basic federal tax to 67.3% of basic federal tax. This would increase the top marginal income tax rate (not including surtaxes) from 45% to 48.5%. A shift to a combination of income and sales taxes would require a sales tax rate increase to 9% from the current 8%, (increasing sales tax revenue by approximately 13%) and an increase in the Ontario income tax rate from 55% of federal tax to 63.4% of federal tax, increasing personal income tax revenue by 15%. The top marginal income tax rate (not including surtaxes) would increase from 45% to 47.4%.

Replacing the $2.2 billion in non-residential property taxes with a payroll tax, for example, would require an 81% increase in payroll tax revenues. The payroll tax rate would have to be increased to 3.5% from the current level of 1.95%.

Personal income tax

The Ontario personal income tax is administered and collected by the federal government through a federal-provincial tax collection agreement. While this arrangement simplifies the administration of the tax for the government and compliance with the tax for the taxpayer, it gives the provinces limited flexibility to set income tax policy.

Under the agreement, the basis for Ontario's income tax is the amount of federal tax payable before a series of special federal-only credits are taken into account. Ontario tax is determined as a fixed percentage of this Basic Federal Tax. For the tax year 1992, the Ontario tax rate is 54.5% of Basic Federal Tax. Effective for the 1993 tax year, Ontario's tax will be 55% of Basic Federal Tax.

Provincial governments have some flexibility in applying various kinds of credits, reductions and surtaxes to the provincial tax payable resulting from this calculation. Since the mid-1970s, provincial governments have implemented a variety of tax credits and tax surcharges that alter the impact of their income taxes on the poor and on high-income taxpayers. However, the basic structure of the tax has continued to be determined by the federal government.

Quebec is the only province that levies its own personal income tax.

Ontario-specific tax provisions include a tax credit with one component linked to property taxes or rent and another component intended to offset the impact of sales taxes on the poor (the Property and Sales Tax Credits), tax credits based in part on age (the Seniors Tax Credit), special measures designed to eliminate tax for taxpayers with the lowest incomes (the Ontario Tax Reduction) and surtaxes on Ontario income tax payable above various amounts.

Taxes and families

> *"... middle-income families pay too much tax because the tax system doesn't adequately recognize the impact of responsibility for children on a taxpayer's ability to pay."*

Prior to 1992, three federal programs provided benefits to families with children. The Family Allowance program provided a universal benefit that, in effect, recognized the contribution made to society by those

who take responsibility for children. The non-refundable credit (a credit that can reduce a taxpayer's liability to zero, but cannot result in a refund) recognized the impact of having the responsibility for children on a taxpayer's ability to pay. And the refundable child tax credit delivered income-tested benefits to low- and moderate-income families. A refundable tax credit is one which is paid as a cash refund to the extent that it is not required to reduce taxes otherwise payable to zero.

In 1992, the federal government introduced significant changes to benefits linked to responsibilities for children. These changes eliminated the family allowance, the non-refundable child tax credit, and refundable tax credit for children. These were replaced as of January 1993 by a single, income-tested Child Tax Benefit paid on a monthly basis. The income test for the benefit is the taxpayer's income tax return from the previous year.

These changes reflected a view that tax provisions relative to children should emphasize anti-poverty goals rather than other objectives.

As a result, for most middle income taxpayers, the income tax system no longer recognizes the impact of having responsibility for children on their ability to pay.

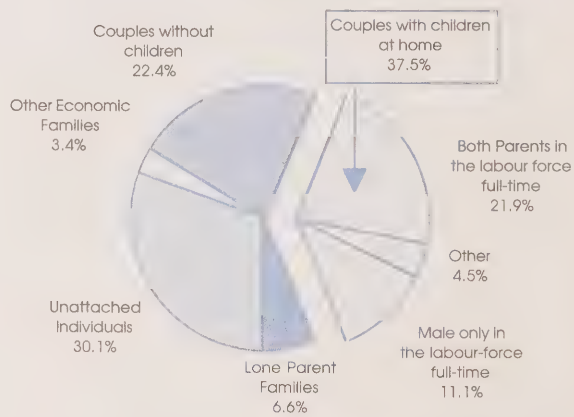
This raises the question: What family relationships, if any, should be recognized in determining ability to pay? And to what extent should these relationships be recognized?

How these questions are answered is as much related to how we consider families in the 1990s as it is to issues of tax fairness. Is there such a thing as a typical family?

The income tax system in Canada was designed with a certain type of family in mind – a family consisting of one spouse in the labour force, one spouse not in the labour force and dependent children. While this type of family may have been the norm when the income tax system was originally designed, it is not today. The extent to which what is "typical" has changed is evident from figure 21 which shows the many different kinds of families or households which existed in 1989, and the labour force participation of couples with children at home.

In 1989, 6.6% of all households were single-parent families, the vast majority of these headed by a woman; 22% consisted of couples with no children at home; almost a third consisted of unattached individuals; and 3% of Ontario households consisted of other kinds of family arrangements, for example, two sisters living together.

FIGURE 21
The Changing Face of the Family:
Household Types and the Labour Force Participation of Couples with Children at Home, Ontario, 1989



Source: FTC calculations based on Survey of Consumer Finances, 1989.

Only 37% of the population of Ontario consisted of couples with children at home. Of those, 58% were families in which both parents worked full time. Only 16% of all households – fewer than one household in six – consisted of couples with children in which both parents were not in the labour force full time. In 56% of lone-parent families, the parent was in the labour force full-time.

These changes in the nature of families in general, and the role of women in particular, may have implications for tax provisions intended to reflect the impact of family relationships on ability to pay.

The Women and Taxation Working Group recommended that a credit for dependent children be reintroduced. In addition, it recommended changes to the definition of "spouse" and changes to the marital credit, a non-refundable credit now called the married amount (Fair Tax Commission 1992f).

The Low Income Tax Relief Working Group of the Fair Tax Commission also recommended that the income tax should include provisions designed to recognize the impact of responsibility for children on ability to pay, especially given the reduced ability to pay of a sole support parent (Fair Tax Commission 1992b).

The tax treatment of children differs in families where the parents are separated or divorced. Support payers (who are mostly men) may deduct from taxable income the full amount of qualifying support payments. Support recipients (who are mostly women with children) are required to report these payments as income for tax purposes. According to the study, *Evaluation of the Divorce Act* (Department of Justice 1990), women were awarded sole custody of the children in three-quarters of the cases and in 98% of the cases, the direction of support is from the father to the mother. The income tax treatment of spousal support is the same as the treatment of child support.

The Women and Taxation Working Group asked the following questions:

- To what extent does the current tax system promote or maintain a disparity in the standard of living between separated women and men, and between custodial and non-custodial households?
- Do the tax provisions relating to support disproportionately subsidize one parent's support obligation even though, according to family law policy, support is to be shared between the parties based on need and relative ability to pay?

The working group recommended that child-support payments not be deducted or included in the calculation of taxable income. This would treat child-support costs in the same manner for tax purposes for custodial and non-custodial parents. It would also result in equal treatment of child-support costs between families in which parents live together and those in which parents are separated or divorced.

For ease of tax administration, and to avoid the introduction of complex anti-avoidance measures, the group also recommended that spousal support payments be treated in the same manner and that transitional provisions be established for agreements negotiated under the current provisions.

Taxes and women

> *"... there's no discrimination against women in the tax system; everything applies exactly the same way to both men and women."*

In 1988, 67% of women with children under the age of 16 were participating in the paid workforce (Statistics Canada 1990). At the same time, women continue to perform the majority of the unpaid work of caregiving and household operation.

Women are less well-off than men whether the measure of well-being is total income or earnings from employment, and regardless of the type of household in which they live. In Canada in 1991, women who worked full time for a full year earned an average of 69.6% of the average earnings of men. (The Ontario figure was 69.8%). The average earnings of women in Canada (both full time and part time) are 61.5% of the average earnings of men (Statistics Canada 1992a). Women are more likely to be poor than men and less likely to have high incomes.

The key tax fairness question is: to what extent does the tax system contribute to this inequality?

A careful review of income tax statutes would reveal nothing explicit in the income tax that identifies women in particular. There are no special rules for women's income as distinct from men's income. There are no special deductions that men qualify for but women do not.

However, the application of these gender-neutral rules may have a different impact on women than on men, giving rise to problems of systemic discrimination. Systemic discrimination is more difficult to identify clearly than legal discrimination and more difficult to address through tax reform alone.

The Working Group on Women and Taxation concluded that systemic discrimination in the tax system may arise from a number of sources (Fair Tax Commission 1992f).

First, because women have lower incomes than men, the effects of the tax system reflect the inequality in the economy on which it is based.

As a result, tax system changes that affect the relative positions of taxpayers with different levels of income will have a different impact on women than on men.

Second, the design of the basic elements of the tax system inevitably reflect certain views regarding what is typical in family structures and in the roles of various family members within the family and in the economy. Women find themselves increasingly in family settings that do not fit the view of the family reflected in the design of the tax system. To the extent that women and men are not represented equally in roles that receive different treatment in the tax system, unequal treatment will result.

The contrast between the roles actually played by women in the economy and the roles around which the tax system is designed calls into question the basis for tax provisions such as the marital credit and the transferability of other credits between spouses.

Women and Taxation Working Group members were divided on this issue. Some members felt that the marital credit should be eliminated altogether along with the transferability provisions. Other members were not prepared to go that far, but felt that as a dependency credit, it was inappropriately conceived. They also felt that the autonomy

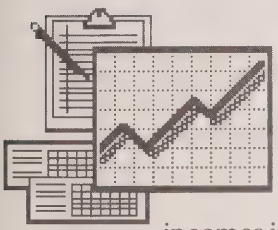
of women would be enhanced if the value of all of these credits were based on their value to the spouse claiming them and then paid as a refundable credit to the spouse with the lower income.

Third, the use of the tax system to deliver benefits can, depending on the nature of the benefit and the form in which it is delivered, result in the benefits being distributed in inverse proportion to need.

The issues that arise from the use of the system to deliver benefits such as child care assistance and retirement saving subsidies are addressed specifically in the section of this paper dealing with the use of the tax system for other policy purposes.

Tax rates

Because the personal income tax is a progressive tax, the schedule of rates increases progressively as taxable income increases.



For 1992, three tax rates apply in the federal income tax rate schedule. The lowest rate of 17% applies to taxable incomes in the lowest range of incomes or tax bracket, from $0 to $29,590. The next higher rate of 26% applies to taxable income over $29,590 but less than $59,180. (For instance, if your taxable income is between $29,590 and $59,180, you still pay 17% on the first $29,590, but you pay 26% on the amount of your income that is between $29,590 and $59,180.) The highest rate of 29% applies only to taxable income above $59,180. However, the first $59,180 of taxable income is taxed at the applicable lower rates. The federal government also applies a basic surtax of 4.5%, and a high-income surtax of 5% for those whose federal tax exceeds $12,500.

Ontario's income tax rate schedule is determined directly from the federal schedule. The rates in 1992 were 54.5% of the federal rates. The ranges of income to which these rates apply, the tax brackets, are exactly the same as the federal tax brackets.

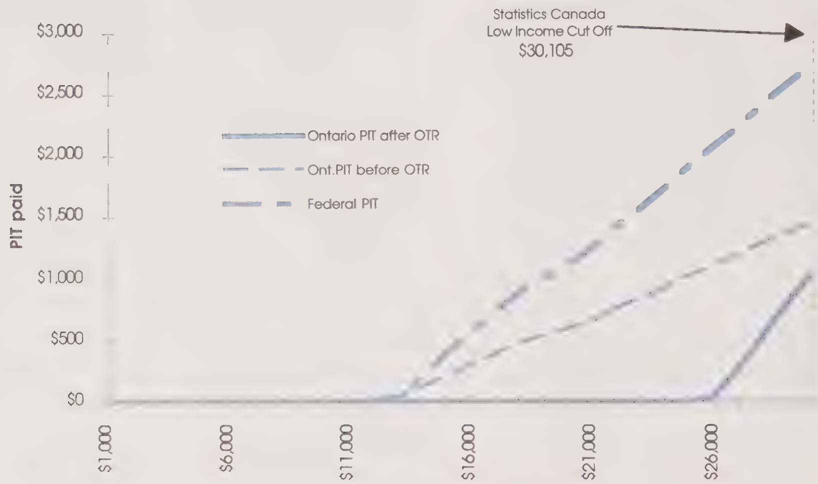
The Ontario Tax Reduction program reduces or eliminates personal income tax for some lower-income taxpayers who pay federal income tax, by providing a credit based on family characteristics to offset all or a portion of the Ontario tax that would otherwise be payable. For higher-income taxpayers, Ontario imposes various surtaxes. The surtaxes are 7% on Ontario income tax above $5,500 and an additional 7% on Ontario income tax above $10,000. Ontario tax reductions for low-income taxpayers and Ontario surtaxes on taxpayers in the higher income range mean that only for middle-income taxpayers is the schedule of tax rates determined entirely by the federal rate schedule and the Ontario percentage of basic tax.

It is estimated that for 1992 about 10.5% of tax filers will benefit from the Ontario Tax Reduction Program and 8.8% of tax filers will pay Ontario surtax (estimate from the Taxation Policy Branch, Ontario Ministry of Finance).

The impact of the income tax on people in various income ranges can be changed in three ways:

- by changing the way income is defined, so that income that is not fully included in taxable income is brought into the definition of taxable income (such as taxing capital gains at 100% instead of the current level of 75%) or so that income currently included in the definition of taxable income is excluded;
- by changing the deductions and credits allowed in the system;
- by changing the schedule of tax rates that apply to Ontario income taxpayers.

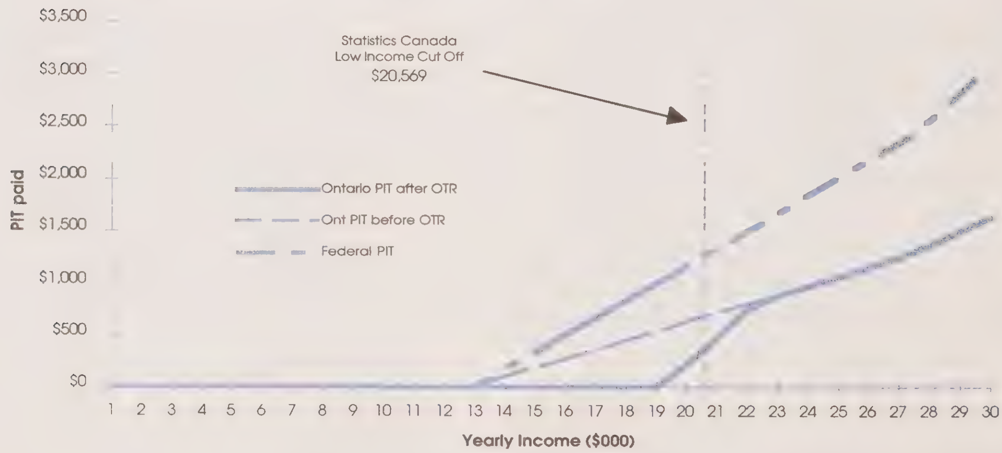
FIGURE 22
ONTARIO TAXES FOR A COUPLE, UNDER 65, TWO CHILDREN, 1992



Source: FTC calculation.
Note: Two earners, income split 1/3:2/3; does not include refundable credits.

Figures 22 and 23 outline the relationship between income and income taxes for taxpayers in two types of families: a couple under age 65 with two children, and a single-parent family with one child. For the couple with two children, it is assumed that both parents are in the workforce, with two-thirds of the income earned by one spouse and one-third by the other. Provincial and federal taxes are shown separately to illustrate the impact of the Ontario Tax Reduction (OTR) program.

FIGURE 23
ONTARIO TAXES FOR A SINGLE PARENT, ONE CHILD, 1992



Source: FTC calculation.
Note: Does not include refundable credits.

Issues related to how income is defined in the tax system, and to the credits and deductions that are allowed, are addressed in subsequent sections of this discussion paper.

Changing the schedule of tax rates is the most powerful and direct way to alter the relative impact of the income tax system on taxpayers in various income ranges. Through changes in the rate schedule, Ontario could reduce or increase the amount of tax paid by low-income tax filers; make income tax payable more or less sensitive to differences in income among taxpayers with incomes in the middle-income range; and reduce or increase the rate of tax paid by high-income taxpayers.

However, because the great majority of tax filers in Ontario earn between $25,000 and $50,000, changes in tax rates for low- and moderate-income tax filers have a greater impact on overall tax revenues while changes in the tax rates applicable to very high-income taxpayers have a relatively modest impact. This is because a smaller percentage of tax revenue comes from very high-income taxpayers than from middle-income taxpayers.

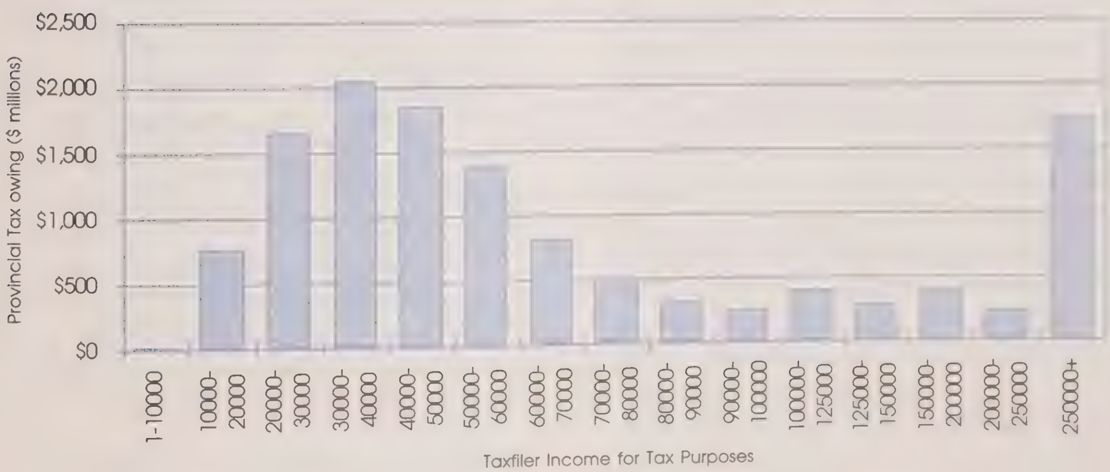
Figure 24 shows the amount of Ontario income tax raised from tax filers in various income ranges.

Impact of high marginal tax rates

> *"... it's not fair that marginal income tax rates are so high – after a certain point, the government gets most of the money you earn."*

When most people talk about the income tax rate they pay, they talk about their marginal tax rate – the rate they pay on increases in their incomes. One of the most common complaints about the income tax is that the rates make it unattractive to taxpayers to increase their income.

FIGURE 24
ONTARIO INCOME TAX REVENUE BY INCOME RANGE, 1989



Source: FTC calculation using Revenue Canada microdata file.
Note: Tax owing is net of non-refundable credits.

In fact, the highest marginal tax rate for an Ontario taxpayer, including all provincial and federal surtaxes, is 50.5%. Average tax rates – the total amount of tax paid as a percentage of taxable income – are much lower. Average tax rates are generally lower than marginal tax rates for two main reasons:

- The marginal rate does not apply to all income. As already illustrated, it applies only to income in a certain range. For example, an individual whose taxable income was $60,000 in 1992 paid tax at a marginal rate of 49% (including surtaxes). That means that for each additional dollar of income earned over $59,180, federal and provincial taxes combined were 49 cents. The 49% rate does not apply to the entire $60,000. It applies only to the portion of the taxpayer's income that exceeds $59,180.

  Total tax as a percentage of taxable income (the average tax rate) in this example is 35%.

- Various credits reduce the amount of tax actually paid on a given amount of total taxable income. For example, credits based on marital status and disability do not affect taxable income, but reduce the tax actually paid on a given amount of taxable income.

Other elements in the tax system affect taxes paid in relation to total income. These elements either add to or subtract from the taxpayer's income in the calculation of total income. Again, there are two main reasons why taxes in relation to total income (effective tax rates) may differ from taxes in relation to taxable income (average tax rates).

- Income from some sources is treated differently in the tax system than income from other sources. As a result, the same amount of cash income can result in different amounts of taxable income, depending on the source of the income.

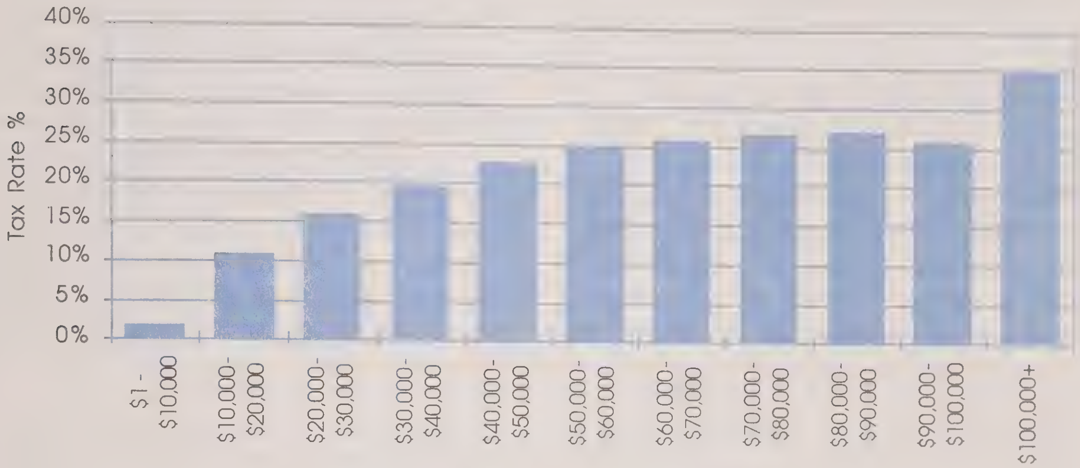
- In addition to raising revenue, the tax system also serves as a mechanism for testing eligibility according to income for certain benefits and recovering those benefits from taxpayers who do not meet the income qualifications. For example, taxpayers whose taxable income exceeds a certain level are required to pay back benefits received, such as unemployment insurance benefits and Old Age Security.

When all of these factors are taken into account, the average effective tax rate paid in various income classes is substantially less than the marginal rates that appear in the published schedules. Figure 25 presents the average effective rate of tax actually paid by taxpayers, by income class. This figure shows, for example, that personal income tax payers with incomes between $50,000 and $60,000 pay approximately 25% of their income in tax. Taxpayers with incomes between $80,000 and $90,000 pay approximately 27% of their income in tax.

It should be noted that these effective tax rates are averages for the income ranges shown. Figure 27 on page 70 shows that there are substantial variations around those averages within each income range. This means, for example, that while the average effective tax rate for taxpayers in the $90,000 to $100,000 income range is 27%, roughly half of the taxpayers in that range pay tax at an effective rate of over 31%.

There are important issues arising from the impact of high marginal tax rates on the economic behaviour of individuals.

FIGURE 25
AVERAGE EFFECTIVE TAX RATE BY INCOME RANGE: ONTARIO, 1989



Source: FTC calculation using Revenue Canada microdata file.

Although it is difficult to measure these effects precisely, it is often argued that high marginal tax rates act as a disincentive to economic activity (work, investment, and so on) by reducing the after tax benefit the taxpayer receives from additional economic activity.

Concerns about these effects led, in part, to the movement throughout western economies in the 1980s to reduce top marginal tax rates in their income tax systems. The policy question that arises is: "How high is 'high' for marginal tax rates?"

High marginal tax rates and the poor

> *"... it's not fair that poor people pay so much more in tax when their income goes up. It can actually cost people money to go into the paid workforce."*

The impact of high marginal tax rates is not an issue limited to high-income taxpayers. Moderate- and low-income families and individuals can also face high implicit marginal tax rates, both directly through the tax system, and indirectly through the operation of other programs.

In the tax system, high rates of tax can arise from the administering of income tests that must be met to qualify for benefits delivered in other programs. Rather than administer the income test directly at the time the benefits are delivered, the benefits are paid out and then recovered, or "clawed back" by requiring repayment through the tax system at a fixed percentage rate on income above specified threshold amounts. Although these repayments are not, strictly speaking, taxes they have the effect of increasing the implicit marginal tax rates faced by taxpayers.

Unemployment insurance recipients face a "tax back" of 30 cents for each dollar of net income over $55,380 (1992) to a maximum of 30% of their UI benefit. (This applies to income earned in the same year benefits

are received.) Old Age Security recipients bear an additional tax of 15% on income over $53,215 (1992) to a maximum "tax back" of 100% of their OAS benefits.

A marginal tax rate issue arises from design of the marital credit and other tax credits such as the GST credit and the Ontario sales and property tax credits for which eligibility is based on family rather than individual income. The marital credit is reduced in its value to a higher-income spouse as the income of the lower-income spouse rises above $538. The spousal credit reduces federal taxes by $915 and provincial taxes by an additional $499 in 1992. This means that when a spouse enters the paid workforce, the family's taxes begin to increase virtually from the first dollar earned.

When a single tax filer enters the workforce, taxes increase only after a threshold level of income is reached. For low-income families, the reduction of tax credits as family income increases acts as an additional barrier to a spouse entering the workforce. When a spouse enters the workforce, the family's income increases and the credits to which the family is entitled go down. In effect, the marginal tax rate on the spouse's income is increased as a result.

The Women and Taxation Working Group considered as an option the elimination of the marital credit on the grounds that it a disincentive to women's participation in the paid labour force (Fair Tax Commission 1992f).

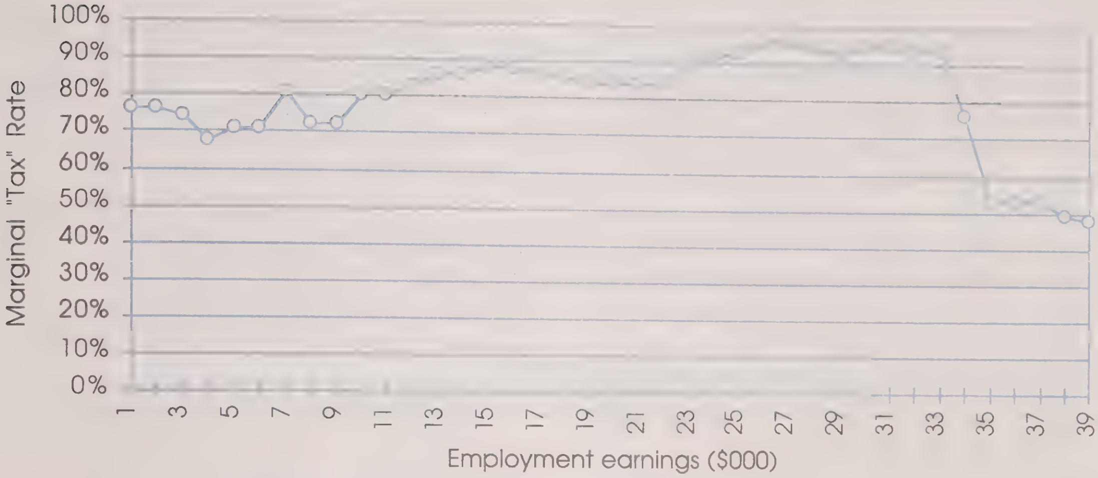
The Working Group on Low Income Tax Relief (1992b) addressed the fact that through the interaction of the tax system and the social assistance system, poor families face very high implicit marginal rates of taxation in Ontario. Families whose income comes from social assistance benefits face both the explicit tax rates in the income tax system and implicit tax rates in the social assistance system. These implicit social assistance tax rates arise because social assistance benefits are reduced by 75 cents for each dollar of additional net income earned, after income from other sources reaches a relatively low threshold amount. This means that in addition to whatever marginal tax rates the family faces through the tax system, it faces an implicit tax on its social assistance benefits.

A study for the FTC provides some illustrations of the levels that these marginal tax rates reach for poor families in Ontario.

Figure 26 shows the very high tax rates faced by a one-earner couple with two young children, which is caused by the interaction of welfare benefit reductions with the payment of social insurance premiums and income tax as earnings increase. The implicit marginal tax rate begins at a high level (76%) and peaks at 96%. Only when the family completely breaks free of the welfare system, at earnings of about $35,000, does the implicit marginal tax rate fall to 53%. The marginal rate does not fall to statutory rate levels until the effects of the tax back of credits such as the Ontario tax credits and the GST credit are absorbed. As earnings increase from $1000 to $34,000 (the earnings range within which the family is still eligible for some social assistance), disposable income increases by only about $5000. Needless to say, this scenario hardly provides a strong incentive for employment.

In 1992, a single parent with one child aged two faced equally high marginal tax rates. When annual employment earnings reach

FIGURE 26
MARGINAL TAX RATES FOR A ONE-EARNER COUPLE WITH TWO CHILDREN, ONTARIO 1992
SOCIAL ASSISTANCE / TAX SYSTEM INTERACTION



Source: Battle and Torjman 1993, "Ontario Social Assistance Review: Implications for Ontario Tax Reform."

$20,000, the marginal tax rate has risen to 95 per cent. The level remains high until the single parent's employment earnings reach $26,000 at which point it drops until it reaches 47% at earnings of $29,000. Disposable income for the single parent with a preschool child increases very little as income increases due to the interaction of the social assistance system and the tax system. As employment earnings increase from $1000 to $27,000, disposable income increases by only $5000 (Battle 1993).

The changes suggested by this analysis would not be simple to implement. In order to address the problem of high marginal tax rates for low-income families arising from the interaction of the social assistance system and the tax system, both the tax system and the social assistance system would have to be changed. It might be necessary, for example, to make social assistance benefits taxable to integrate the two systems. The structure of social assistance benefits would have to be adjusted to take that into account.

Taxes and the poor

> *"... it's not fair that people with incomes below the poverty level still have to pay income tax."*

> *"... it's not fair that I have to pay high taxes to support people on welfare."*

The Ontario Tax Reduction program is designed to reduce or eliminate income tax payments for low-income individuals. However, even after taking into account the effect of this program, 524,925 tax filers in Ontario households with incomes below the poverty line in Ontario paid income tax in 1991 (FTC calculations based on micro-data files from Statistics Canada, Survey of Consumer Finance, 1989 Incomes).

The program allows an amount of $175 for an adult and $375 for every child. If these amounts are equal to or greater than the Ontario tax that would otherwise be payable, the tax is eliminated. If the amount of the reduction is less than two-thirds of Ontario tax, Ontario tax payable is not affected. This means that Ontario taxes are reduced over a relatively narrow range of incomes.

For example, in 1992, for a single parent with two children, Ontario personal income tax (PIT) is eliminated below $23,380 of income, and reduced between $23,380 and $28,650. For 1992, the Ontario Tax Reduction (OTR) program was projected to eliminate Ontario PIT for about 500,000 tax filers who will pay federal PIT. An additional 215,000 tax filers were expected to pay reduced Ontario income taxes. (For the purposes of calculating OTR thresholds, all income is assumed to be from employment and family allowance.)

Even with the Ontario tax reduction, many low-income individuals and families pay provincial income tax. On average, families below Statistics Canada's low income cut-offs (commonly referred to as the poverty line) pay about half of the Ontario personal income tax that they would have paid without the OTR. For example, a couple with two children and poverty-line earnings (for cities with populations between 100,000 and 499,999) of $26,439 in 1992 paid 1.4% of earnings in provincial income tax and 8.8% in federal income tax.

The basic policy question is: should people who are recognized as living in poverty should be treated by the tax system as having an ability to pay income tax? The Fair Tax Commission's Working Group on Low Income Tax Relief (1992b) recommended that the tax system be restructured to en-sure that families with inadequate incomes are not required to pay income tax.

In order to eliminate tax obligations for families at or below the low-income cut-off, without imposing extremely high marginal tax rates on those with incomes just above the cut-off level, the special assistance required to eliminate tax for the poor would have to be phased out rather than eliminated abruptly at the low-income cut-off. As a result, partial tax relief would be provided to people above the low-income cut-off.

In the Ontario Tax Reduction program, for example, the Ontario tax rate for individuals receiving tax reduction benefits is approximately 27%. This rate drops to the normal rate of approximately 9% as soon as the amount of tax payable under the OTR (including the special 27% tax for OTR beneficiaries) equals the regular tax levied at 9% of taxable income.

The Ontario Tax Reduction program currently costs an estimated $134 million annually. However, the program is very poorly targeted. Only 13% of the benefits paid out in the program go to families with incomes below the Statistics Canada low-income cut-off levels. There are two reasons why this is the case. First, the OTR program is based on individual incomes, rather than family incomes. As a result, a portion of OTR benefits go to two-earner families (in which one or more of the tax filers has a low individual income) with total household income above the low-income cut-offs. Second, OTR benefits are triggered by low Ontario taxes, not low incomes. As figure 27 on page 70 illustrates, tax filers who pay very little Ontario tax are found in all income ranges.

If the targeting of the program were improved by moving to family rather than individual tax relief, and the tax relief based on income rather than Ontario tax paid, the program could meet the working group's objective of zero tax at the low-income cut-off level. In addition, this would result in lower marginal tax rates than those in the current OTR program.

For example, the total cost of a program that would eliminate tax for families at the low-income cut-off level for cities with populations between 100,000 and 499,000, while keeping the Ontario tax rate applied to income just above that level below 25%, would be less than the cost of the current program (FTC calculations based on Statistics Canada Social Policy Simulation Database/Model).

However, it bears repeating that changing the income tax system for families with incomes below the low-income cut-off will not remove the burden of tax from the poor. Poor families will continue to pay a substantial proportion of their incomes on sales, gasoline, property and other taxes.

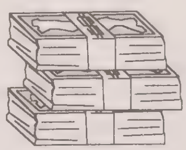
The burden of some of these additional taxes on the poor is addressed through other credits in the Ontario income tax system. The sales and property tax credits, and seniors tax credit all provide credits that are reduced as the income of the household increases. While the property tax credit is at least partially related to the amount of property tax paid by a household, the sales tax credit bears no necessary relationship to the amount of sales tax paid. The seniors' tax credit is based in part on the age of the tax filer and in part on occupancy cost factors that are similar to those in the property tax credit.

Two working group reports addressed issues related to tax credits. The Working Group on Low Income Tax Relief recommended that the sales tax credit be increased to reflect more closely the amount of sales tax actually paid by poor households.

The Working Group on Property Tax recommended that the property tax credit formula be changed to link the credit to property taxes paid, either directly or though residential rents. It also recommended that credits based entirely on age be eliminated.

As presently designed these credits, despite their names, bear very little relationship to the amount that a household pays in the taxes from which they are supposed to be gaining relief. This suggests two general directions for reform. One would be to redesign these credits so their value is closely linked to the amount of sales and property tax paid. The other would be to acknowledge that the credits are essentially unrelated to these other taxes and fold them into the income tax system.

Taxes and the rich



"... it's not fair that high-income individuals can get away without paying any tax."

Although we have a progressive income tax system in Canada that includes a minimum personal income tax, some Ontario personal income tax filers reported relatively high incomes and paid little or no income tax.

Figure 27 shows the effective rates of tax paid by tax filers in various income ranges. Each of the shaded areas represents a range of effective tax rates. For example, the large dark-shaded area that runs across the middle of the chart represents tax filers who pay tax at effective rates of between 21% and 30%.

From the figure, one can read the effective tax rates paid by tax filers in each income range. For example, in the range of $50,000 to $60,000, about 3% of tax filers paid taxes at effective rates of less than 10%. Roughly 14% of tax filers paid tax at effective rates of less than 20%. Approximately 98% of tax filers paid at less than 30%. And 2% paid at effective rates of more than 30%.

What is interesting to note from this figure is the extent to which tax filers paying relatively low effective rates of tax can be found in every income range. In fact, a higher proportion of tax filers reporting incomes in excess of $80,000 pay taxes at effective rates of less than 20%, than of tax filers with incomes between $40,000 and $50,000.

The most dramatic example of this phenomenon is reflected in the often-quoted statistics concerning high-income tax filers who paid no income tax. In 1989, 444 taxpayers reporting incomes above $100,000 paid no income tax. A further 4868 paid out less than 10% of their income in tax (FTC calculation based on Revenue Canada microdata files).

In response to the publication of figures such as these, it is often countered that the phenomenon of high-income earners paying no tax is not real, that it appears to exist because of inconsistencies in the way investment income and related interest expenses are dealt with in the tax system. For taxpayers who carry on investment as individuals rather than through a corporation, all investment income is included in total income. Deductions for interest costs on money borrowed for investment are reported separately. As a result, the taxpayer's income appears to be higher than it really is. The validity of this counter-point

FIGURE 27
DISTRIBUTION OF TAX FILERS BY INCOME TAX PAID AS A PERCENTAGE OF INCOME, ONTARIO, 1989

Source: FTC calculations based on Revenue Canada microdata file.

can be tested by adjusting income to reflect all capital gains and losses, reducing dividend income by the amount added for the dividend tax credit calculation and reducing income by the amount of interest paid on funds borrowed for investment.

When the data are adjusted in this way, the numbers of high-income taxpayers paying little or no tax actually increases. This increase results from the fact that adding capital gains back into income results in individuals whose incomes were below $100,000 moving into the "over $100,000" category. The adjusted data show that 779 individuals with incomes over $100,000 pay no income tax. A further 13,167 tax filers with incomes over $100,000 pay less than 10% of their income in tax (FTC calculation based on Revenue Canada microdata files).

It is also suggested that this phenomenon can be explained by losses from farming, business activity or rental real estate. However, this is only a partial explanation. Of the 779 tax filers with reported incomes of over $100,000 who paid no tax, 106 had negative farming income, 51 had negative business income and 52 had negative rental income (FTC calculation based on Revenue Canada microdata files).

These statistics do not reflect illegal activities such as failing to report income or claiming illegitimate deductions. Tax evasion doesn't show up in the income tax statistics. These statistics arise from the impact on the taxes paid by individuals of legitimate provisions of the Income Tax Act that protect some sources of income from tax, permit deductions from income in the calculation of taxable income or enable taxpayers to claim credits against the tax that would otherwise be payable.

Substantial differences in effective tax rates exist in all income ranges. This has direct implications for tax reform. First, it means that changes in the structure of tax rates will not address all of the equity issues in the income tax. Second, it means that an attempt to alter patterns of effective tax rates through rate schedule changes alone will impose disproportionate burdens on some taxpayers in any given income range. For example, an attempt to increase the effective tax rate on taxpayers with incomes above $100,000 a year by increasing the top marginal rate would result in some taxpayers facing extremely high effective tax rates while others with the same incomes would essentially be unaffected, continuing to pay tax at relatively low effective rates.

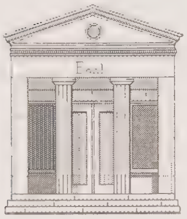
Is a buck really a buck?

"... it's not fair that the income people earn from investments is taxed at a lower rate than income from employment."

One of the major reasons why high-income individuals might pay tax at a lower effective rate is that certain kinds of investment income are treated differently in the income tax system than other sources of income. Both capital gains and dividend income from Canadian corporate shares receive special treatment.

Capital gains on investments receive favourable treatment in two respects. First, each individual is entitled to receive a lifetime total of $100,000 in capital gains income tax free (in addition to the capital gain from the sale of a principal residence, which is neither reported nor taxed).

Small business and farm assets are covered by a separate $500,000 lifetime-gains tax exemption. Second, 25% of any non-exempt capital gain is excluded from income in the calculation of taxable income – the balance is the "taxable capital gain."



There are two main reasons advanced for special treatment of capital gains in the income tax system. One is based on notions of tax fairness; the other is based on policy objectives related to the stimulation of investment activity. The tax fairness argument for the exclusion of 25% of capital gains from income taxation is that it is necessary to compensate investors for the fact that the cost of acquiring assets that are taxable for capital-gains purposes is not indexed for inflation.

For example, consider an asset that increased in value from $100 to $150 over a two-year period. If inflation over that period was 10%, then $10 of the gain is actually the result of general inflation in the economy. Those who make the inflation argument for the capital gains exclusion argue that this is not a real increase in value and as such, should not be taxed. They argue that, after allowing for inflation, capital gains are more heavily taxed than other forms of income. Others reject the inflation argument, suggesting that allowing investors to deduct the full amount of interest on money borrowed to acquire investment assets, along with the fact that the gain is taxed only when it is realized, more than compensates for the fact that the acquisition cost is not indexed.

It is also argued that both the 25% exclusion and the various lifetime exemptions are needed to encourage investment activity.

Dividends on Canadian corporate shares benefit from the operation of the dividend tax credit system. Although the dividend tax credit is sometimes described as an incentive to Canadians to buy shares in Canadian corporations, its effect (some would argue its major purpose) is to integrate the personal and corporate income tax systems. For income earned by small businesses, integration refers to having income earned in a corporation and distributed to shareholders taxed at the same effective rate as if it had been earned directly at the individual level.

The dividend tax credit works as follows: The amount of the dividend that a corporation pays to a Canadian shareholder is increased by 25%, which theoretically makes the increased amount equal to the before-tax income originally earned by the corporation. This adjusted income is then taxed at the marginal tax rate of the individual shareholder. The resulting tax is then offset by a credit of 13.33 % of the increased or "grossed-up" dividend amount. This produces roughly the same tax result as if the individual had earned the income directly. It should be noted that for income earned by corporations not taxed at the small business rate, this relationship between corporate and individual taxes does not exist.

There are two key arguments advanced for the dividend tax credit. One is that it is a necessary incentive for Canadians to invest in the shares of Canadian corporations. The other is that the dividend tax credit enhances the fairness of the tax system by eliminating the double taxation that would result if the corporate and personal income tax systems were treated as entirely separate.

The integration of the personal and corporate income tax systems through the dividend tax credit is based on the idea that the burden of a tax on the income of a corporation is ultimately borne by the shareholders who are the owners of the corporation. Although corporations and their shareholders are separate legal entities, a tax on the earnings of the corporation is really a tax on the shareholders.

As a result, it would be double taxation to tax both the corporate income on which a dividend is paid in the hands of the corporation and the dividend itself in the hands of the shareholder.

To address this issue, most countries provide for some form of integration of their personal and corporate tax systems. U.S. tax law recognizes the problem of double taxation through special rules that apply only to small business personal corporations. However, U.S. tax law does not provide for integration for corporate dividends generally. It implicitly accepts the idea that corporate organization separates the activities of the corporation from the activities of the individual shareholder sufficiently so that corporate taxes should be independent of the taxes paid by the shareholders, except in the special circumstances of closely-held small businesses.

For large businesses, the Canadian dividend tax credit may result in the shareholder getting less as a credit than the amount of tax that was actually paid by the corporation on the income from which the dividend was paid. However, in other cases the shareholder receives a credit that is greater than the tax that was actually paid by the corporation on the income from which the dividend was paid. Shareholders benefit from dividend tax credits even when the corporation that paid the dividend paid no corporate tax.

The special tax provisions for capital gains and dividend income are costly in revenue foregone. In 1989, the exclusion of 25% of capital gains reduced provincial personal income tax revenue by $267 million. The $100,000 and $500,000 exemptions reduced provincial revenue by a further $529 million. The provincial tax expenditure for the dividend tax credit (after both gross-up and credit) was $162 million in 1989 (see table 4, below, page 77).

To some extent, the policy questions that arise from these provisions depend on what their purpose is assumed to be.

- If they are seen as necessary elements of a fair tax system, do they in fact enhance the fairness of the system?
- Is inflation protection a valid basis for the capital gains exclusion?
- Should the personal income tax and corporate income tax be integrated?
- If these measures are seen as important incentives for investment activity, are they achieving the desired effect at reasonable cost to other taxpayers?

Even if it is agreed that the Canadian tradition of integrating personal and corporate taxes on dividends should be continued, the current system raises important policy questions. Under the current system, the amount of corporate tax for which a shareholder gets credit is completely independent of the amount of tax actually paid by the corporation.

Using the tax system to achieve other policy objectives – is it a good idea?

> *"... providing subsidies though the tax system to people for such things as retirement saving or child care makes the system more unfair."*

The tax system isn't used only to raise revenue. It is also used to deliver other benefits and programs which could, in principle, be delivered through direct grants to individuals.

The tax system is an attractive way to deliver some kinds of program benefits for a number of reasons. First, the additional administrative costs associated with delivering an additional benefit through the tax system are relatively small. Second, delivery of a program through the tax system broadens its reach, because virtually every adult Canadian files a tax return. Third, the tax system is particularly well suited to delivering grants and subsidies that are income tested. No separate reporting of income is required. And benefits are delivered anonymously, without the stigma often associated with separately-delivered social assistance benefits.

However, as the use of the tax system as a delivery mechanism for other programs increases, significant concerns arise. Particularly where the tax system is used to provide incentives or subsidies that are linked to discretionary expenditures rather than to deliver grants based on income or family composition – the presence of children, for example – these tax expenditures raise issues of fairness.

To the person who benefits from these provisions, they are "incentives". To the person who does not benefit from them, they are loopholes or tax breaks. Their existence creates opportunities for taxpayers to structure their affairs to minimize the amount of tax they pay. The fact that these provisions or "tax planning opportunities" are not equally available to everyone contributes to the feeling that many people have that the tax system is not fair.

Using the tax system to deliver program benefits affects public perceptions of tax fairness. Important questions also arise concerning the appropriateness of using the tax system as a substitute for direct expenditure programs, or as tax expenditures. Although these tax expenditures are substitutes for regular expenditure programs, they are not fully equivalent to direct spending programs that deliver the same benefits in a number of respects.

First, they are generally not subjected to annual budgetary review as are other public expenditure programs. During periods of fiscal restraint, this creates a potential imbalance between support delivered through the tax system and support delivered directly because direct spending programs are more visible and more vulnerable to budget cuts.

Second, the level of spending and its distribution among potential beneficiaries cannot be managed by government the way it can in a direct spending program. In fact, this information is only available after the fact, when income tax returns have been filed and processed. This creates the potential for a tax expenditure to run out of control for a considerable period of time before anyone notices that there is a problem.

The most celebrated example of this was the ill-fated federal Scientific Research Tax

Credit. This credit, which was abused on a massive scale, generated total spending far beyond what was originally predicted without a significant increase in the type of investment it was designed to encourage. By the time enough was known about the problem for the government to respond, at least $1.6 billion in revenue had been lost (Auditor General 1984).

Third, tax expenditures are generally designed and administered by tax officials who are experts in tax but not in the public policy area that the tax expenditure is designed to influence.

Fourth, for certain types of equivalent-to-expenditure benefits, the tax system is an extremely blunt delivery instrument. For example, it is virtually impossible to design a disability benefit that can be effectively delivered through the tax system that has any sensitivity to the degree of disability a person experiences. It is also difficult to tailor a tax benefit to differences in shelter costs relative to income or to match the timing of benefits to the timing of costs.

Fifth, tax expenditures, other than those designed specifically to deliver income supplements, tend to weaken the link between income taxes and the ability to pay of the taxpayer. All such tax expenditures undermine horizontal equity – they result in having taxpayers with the same incomes pay different amounts of tax because one can take advantage of the tax benefit while another cannot. This is true whether the tax expenditure is delivered through a tax credit or a tax deduction.

Some tax expenditures also create problems for vertical equity, because they are leveraged benefits, in the sense that the taxpayer only can get the benefit if he or she has sufficient disposable income to make the expenditures that qualify for the benefit. For example, many of the people who most need financial assistance for retirement savings do not have the disposable income required to make the RRSP contributions that trigger the government subsidy.

The form in which the benefit is delivered – as a deduction from income or as a credit against taxes – is also important. If the benefit is delivered in the form of a deduction from taxable income, it introduces an element of "upside-down equity" into the tax system. For the same amount deducted, the higher a taxpayer's income, the greater the value of the deduction. Where a tax expenditure is delivered in the form of a tax deduction, even where taxpayers can claim the same amount, the progressive rate schedule guarantees that the benefit will be worth more in the form of reduced taxes to a higher-income taxpayer than to a lower-income taxpayer.

A given reduction in a taxpayer's taxable income is worth more, the higher the top rate of tax paid by the taxpayer. For example, a deduction of $1000 saves $500 in taxes for a taxpayer in a 50% tax bracket and only $260 for a taxpayer in a 26% bracket.

It should also be pointed out that not all credits are the same. Some are "refundable," in that a taxpayer who qualifies gets the credit regardless of the amount of tax otherwise owed. Others are "non-refundable." These credits can only be used to reduce tax payable to zero. In effect, with non-refundable credits, the system is saying that you can benefit from the credit if you would otherwise have to pay tax, but if your income is so low that you do not have

any tax to pay, you cannot benefit from the credit. This may make sense if the purpose of the credit it to reduce taxes, as is the case for the Ontario Tax Reduction program. But applied to most other purposes for which credits might be designed, the result is lower benefits for those with the lowest incomes than for people whose incomes are just high enough that they are required to pay tax.

Although the idea of a tax expenditure is a useful concept in thinking about tax issues, there is a lot of debate about what provisions should be considered to be substitutes for expenditure programs and what provisions should be considered as elements to improve the fairness of the basic tax system.

For example, some see the dividend tax credit as an incentive to invest in Canadian stocks. Others see it as a way of avoiding double taxation of business income. Those who see it as an investment incentive would describe the dividend tax credit as a tax expenditure. Others, who see it as a mechanism for avoiding double taxation, would not. However, to the extent that the value of the dividend tax credit exceeds the amount of tax paid by the corporation, the credit could be seen as a tax expenditure even by those who accept the double-taxation rationale.

Whether a tax expenditure is desirable or undesirable can be resolved only on a case-by-case basis. An analysis of a tax provision's value as an expenditure program then becomes one of a number of considerations that might go into deciding whether that provision should be continued unchanged, modified or eliminated. However, regardless of how it is categorized, each provision of the income tax can be analyzed to estimate the total amount of tax revenue that would have been collected if the particular provision did not exist. In addition, published income tax data make it possible to identify the incomes and some other household characteristics of those who claim the benefits.

Table 4 summarizes the major provisions of the income tax that might be considered tax expenditures. For each provision, the table provides an estimate of the Ontario tax revenue foregone as a result of the presence of that provision in the Income Tax Act. It does not include federal income tax revenue foregone. For example, it is estimated that the special treatment of capital gains (the exclusion of 25% of gains from tax, the $100,000 lifetime exemption and the special $500,000 exemptions for farming assets and small business shares) reduces Ontario income tax revenue by $796 million.

It is important to note that the distributional issues raised by tax expenditures are slightly different from the distributional issues raised by the basic structure of the tax system. In the basic tax system, the distributional issues have to do strictly with society's ideas of tax fairness. Tax expenditures, on the other hand, arise from a decision by government to deliver a program or subsidy through the tax system. The distributional impact of a tax expenditure is in fact the distribution of the benefits from a government program or subsidy among taxpayers. And if the program or subsidy does not stand alone, but is part of a package of programs designed to achieve a policy objective, those distributional impacts should be considered together.

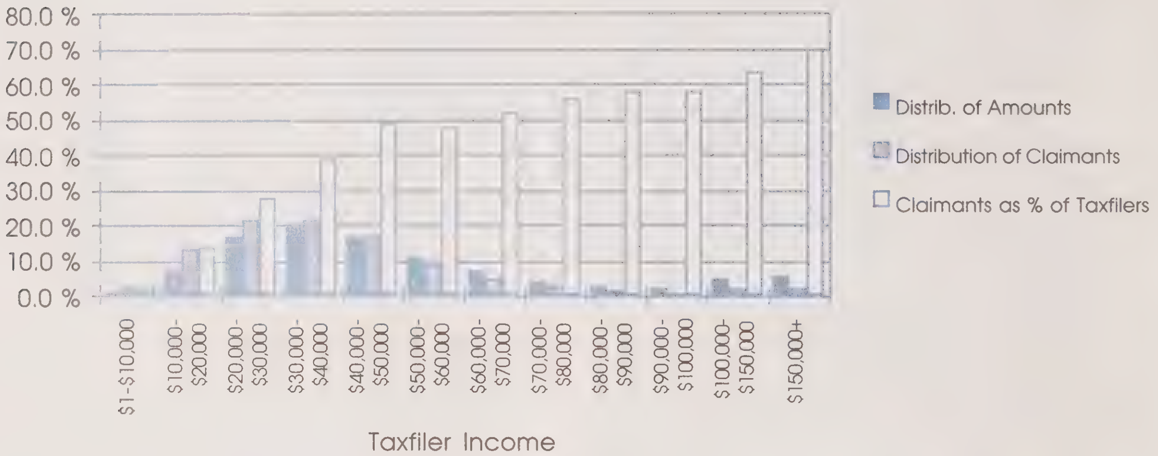
TABLE 4
PERSONAL INCOME TAX EXPENDITURES, ONTARIO, 1989

Personal Tax Expenditures, Ontario 1989	($ Million)
Tax Expenditures Shared with the Federal Government	**Ontario Revenue Foregone**
Deductions and Exemptions	
Registered Retirement Savings Plans	
Deduction for contributions	658
Non-taxation of investment income	516
Taxation of withdrawals	-117
Registered Pension Plans	
Deduction for contributions & non-taxation of employer contributions	654
Non-taxation of investment income	872
Taxation of withdrawals	-603
Capital Gains Exemption	529
Capital Gains Exclusion	267
Union/Professional Dues	68
Child Care Expenses	57
Northern Residents Deductions	9
Alimony & maintenance	35
Non-Refundable Tax Credits	
Age Credit	264
Married Credit (including E-to-M)	219
Charitable Donations	186
Credit for Dependent Children	81
Medical Expenses	37
Pension Income Credit	59
Disability Credit	31
Tuition Fees	37
Education Credit	9
Dividend Tax Credit	162
Tax Expenditures Solely Within Ontario's Jurisdiction	
Property & Sales Tax Credits	407
Ontario Tax Reduction	40
OHOSP Tax Credit	21
Political Contribution Tax Credit	3

Source: Fair Tax Commission 1993a, "Ontario Tax Expenditures." No total is reported because each tax expenditure is estimated independently of the others; the figures reported ignore interactive effects.

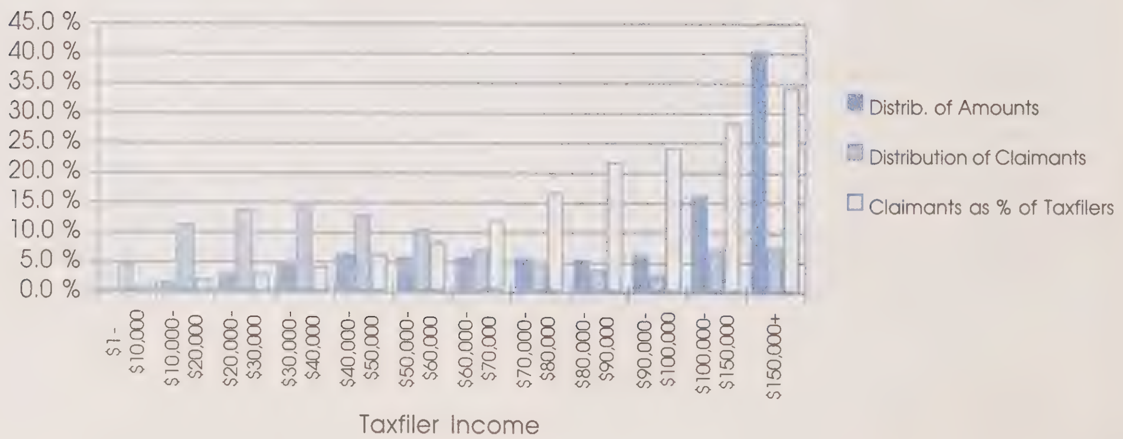
Figures 28, 29 and 30 show how the benefits from various provisions are distributed among taxpayers according to their income. While the benefits from deductions for RRSPs (figure 28) are concentrated among middle- and high-income taxpayers, the benefits from the special treatment of capital gains (figure 29) and the dividend tax credit (figure 30) are concentrated only among higher-income taxpayers.

FIGURE 28
INCOME DISTRIBUTION OF TAXPAYERS WHO DEDUCTED RRSP CONTRIBUTIONS, ONTARIO, 1989



Source: FTC calculations based on Revenue Canada's aggregated database for 1989.

FIGURE 29
INCOME DISTRIBUTION OF TAXPAYERS WHO REPORTED CAPITAL GAINS, ONTARIO, 1989



Source: FTC calculations based on Revenue Canada's aggregated database for 1989.

FIGURE 30
INCOME DISTRIBUTION OF TAXPAYERS
WHO CLAIMED DIVIDEND TAX CREDIT, ONTARIO, 1989

Source: FTC calculations based on Revenue Canada's aggregated database for 1989.

Since the RRSP deduction is designed as a complement to other forms of tax assisted retirement saving, the true distributional picture can only be drawn by looking at the tax treatment of pensions and RRSPs together. Unfortunately, the data currently available do not permit such a comprehensive analysis to be made.

In addition, because these provisions are intended to promote policy objectives other than tax fairness, we have to look beyond the distribution of benefits among taxpayers at various income levels to an evaluation of the merits of using the tax system to promote that policy objective. Child care and the tax expenditure provisions related to retirement saving are addressed below as examples of tax provisions that are designed to achieve other policy purposes.

It should be noted that each of these provisions could be seen as contributing to the fairness of the tax system and not as a tax expenditure. Some people take the position that child care expenses should be deductible because they are a cost associated with employment. Tax-free retirement saving is seen by some analysts not as a subsidy for retirement saving but as a way to allow people to spread their incomes over a longer period of time for tax purposes and thus make their tax liability better reflect their incomes over that period.

Child care

Child-care expenses are deductible from taxable income up to maximum amounts that vary with the age of the child. In 1993, the maximum deduction will be $5000 for each child under age seven and $3000 for each child between seven and 14. For a dependent child of any age with a severe and prolonged mental or physical impairment, the limit is $5000.

There are two major fairness issues concerning the child-care expense deduction. First, it is a deduction from taxable income. As such, the benefit to a taxpayer from a given deduction increases as income increases. Second, in order to claim the deduction, it is necessary to have a receipt for the expenditure. Because 80% of child care in Canada takes place in informal settings where caregivers do not provide receipts (1986 figure quoted in Barnhorst and Johnson 1991, 51), the child care deduction provides no benefit to the majority of people who incur child-care expenses because they cannot qualify for the deduction. A comparison of family expenditure data and income tax data for 1989 suggests that only 42% of families in which all adults work full time and have children age 11 or younger, claimed the deduction for child care (FTC calculation based on Statistics Canada Survey of Consumer Finances, 1989 Incomes; and Revenue Canada,1991, *Taxation Statistics*).

In addition, serious questions have been raised about the value of the program in assisting in the provision of child care. Rather than providing a subsidy that goes to a limited proportion of those who need assistance and is of greatest benefit to those who need the assistance the least, it is argued that the funds should be put towards a direct spending program that is accessible to all families who need child care, regardless of income.

Two working groups of the Fair Tax Commission addressed this issue. Both expressed concerns about the "upside-down equity" involved in providing a benefit in the form of a deduction that is of more value to a high-income taxpayer than it is to a lower-income taxpayer.

The Low Income Tax Relief Working Group recommended that the deduction be converted to a credit (Fair Tax Commission 1992b, 42).

The Working Group on Women and Tax supported the idea of a "universally available, publicly funded child care system" as an alternative to the current tax deduction. Some group members took the position that in the meantime, tax support for child care should be continued. They also recommended that the deduction be converted to a credit and that a minimum credit should be available to parents with children in informal care arrangements. Other group members wanted to eliminate the tax deduction entirely and allocate the resulting increase in tax revenues to public financing of child care (Fair Tax Commission 1992f, 32–36).

Retirement savings

The form of tax assistance for retirement savings that is most obvious to the taxpayer is the tax deduction for contributions to Registered Retirement Savings Plans and Registered Pension Plans. Contributions by individuals are allowed as deductions from taxable income in the year the contribution is made. Tax is deferred and is paid on the RRSP and RPP funds when they are actually received.

In addition to these visible sources of tax assistance for retirement saving, assistance is delivered indirectly through the special tax treatment given pension benefits provided through employer contributions. Most other benefits provided by employers are considered to be taxable to an employee, and added to the employee's taxable income in the year they are earned.

Pensions are taxable only when the pension is received.

Prior to the most recent round of federal income tax reforms, the rules governing these various forms of tax assistance for retirement saving were quite arbitrary. Individuals had different RRSP contribution limits, depending on whether or not they were members of a pension plan. The same limit applied whether you were a member of a good pension plan or an inadequate plan. And if the pension plan you belonged to required that you contribute, that contribution further reduced the amount you could contribute to an RRSP. If you belonged to a pension plan whose entire cost was employer paid, your RRSP contribution limit would have been higher than the limit for someone who was required to contribute.

Reforms to the Income Tax Act that took effect for the first time in the 1991 taxation year have attempted to deal with the fairness problems created by these arbitrary rules. These reforms established a common limit for all forms of tax-assisted retirement savings and a formula that enables the retirement saving represented by the level of pension benefit earned in a year to be added to individual RRSP and pension plan contributions.

The rules governing the operation of this system for integrating the various types of tax assisted saving are very complex, yet take a simplistic approach that leaves many fairness problems unresolved. However, they do provide a basis of comparison for the benefits of the various types of retirement savings arrangements.

The more fundamental policy problem has to do with whether or not providing assistance through the tax system is the appropriate policy response to ensure that Canadians have access to adequate incomes in retirement.

One of the major problems with the current system of tax assisted retirement savings is its coverage. Although it will not be possible to look at the system as an integrated whole until the taxation data from the 1991 tax year are available, there are data on participation in the various elements of the system. Only 50% of men and 39% of women in the paid workforce in 1990 were members of private pension plans (Statistics Canada 1991b).

With respect to RRSPs, 27% of men and 19% of women claimed a deduction in 1988 (FTC estimates based on Revenue Canada 1990 and unpublished microdata). Even ignoring any overlap in these data that would result from the same individual belonging to a pension plan and contributing to an RRSP, the data reveal large gaps in coverage.

In addition, two features of the system link the amount of tax assistance to income. First, the limits on tax assisted retirement saving are tied directly to earned income, up to a maximum amount of tax-free saving. Up to this maximum level of earned income, the higher the taxpayer's income, the greater the amount of tax assistance for retirement saving the taxpayer is entitled to receive. Second, because the assistance is delivered to the taxpayer in the form of a tax deduction, the assistance provided for a given dollar amount of retirement saving is higher, the higher the marginal rate of tax paid by the taxpayer. In a progressive income tax system, this means that higher-income taxpayers receive proportionally more assistance for a given amount of retirement saving than taxpayers whose marginal tax rate is below the maximum.

Tax assistance for retirement saving also delivers benefits to individuals with much higher incomes than other forms of publicly supported retirement income. Old Age Security benefits are reduced for people with incomes above approximately $53,000 at the rate of 15 cents in lost OAS benefit for each dollar of additional income. At present, Canada Pension Plan Benefits do not cover more than 25% of the Yearly Maximum Pensionable Earnings (YMPE). The YMPE is the average wage in Canada, rounded to the nearest $100. For 1993, it is $33,400. In contrast, by 1996, when the new pension tax rules are fully phased in, the maximum level of covered earnings for full tax assistance is expected to be about 2.5 times the average wage (Department of Finance 1989).

The result is that higher-income individuals derive substantially greater benefit from tax assistance for retirement savings than people with lower incomes, while a large number of people get no tax subsidy at all.

The Working Group on Women and Tax addressed the question of the possible differential impact of tax assistance for retirement savings on women and men. It found that women are less likely to belong to a pension plan, are less likely to have an adequate pension plan even when they belong to one, and have less disposable income from which to save for retirement. As a result, the use of the tax system to deliver subsidies for retirement savings through RRSPs and pension plans means that the economic inequality faced by women translates directly into lower subsidies for retirement savings for women than for men, even though women are more likely to need them.

Some members of the working group felt that the problems inherent in delivering retirement income benefits through the tax system were important enough to justify the elimination of tax assistance for retirement and that the foregone tax revenue should be redirected to enriching the public retirement income security system. Others concluded that despite the equity problems with using the tax system to support retirement saving, it is neither practical nor desirable to eliminate these provisions.

The self-assessing taxpayer

"... it's not fair that some people can write off expenses that others can't."

Compliance with Canada's income tax system is voluntary. The system depends on individuals reporting their own incomes on an annual basis. It is also designed to be non-discriminatory, in that it strives to achieve equal treatment of individuals in equal circumstances, regardless of the sources of their income.

As much as we may wish to treat income from different sources the same way, in practice it is very difficult to do so and achieve an equitable result. While our tax system is based on self-reporting, some kinds of income either flow through the tax system automatically or are reported to government and are easily traceable to individuals. Taxes are deducted from wage and salary income as it is earned. For people whose sole source of income is employment, the filing of a tax form is only required to adjust the amount payable because of provisions that are not taken into account by employers in determining the amount to be deducted.

Dividend income from Canadian corporations and interest income from Canadian securities or deposits in Canadian financial institutions are not subject to deduction at source, but income statements are filed and recorded by Revenue Canada by social insurance number, so that the income is relatively easy to attribute to individuals.

The treatment of income from self-employment is one of the areas where the declaration of income is most subject to individual judgement and where the sources of income are not easily attributed to individuals. As such, it may be the most important single contributor to popular perceptions that the tax system is unfair.

Until challenged in an audit, a taxpayer's return is presumed to be in strict compliance with the law.

There are grey areas throughout the system that are open to potential abuse. Some take advantage of the presumption that they have filed correctly to interpret the law to their advantage. Because the percentage of tax returns subjected to audit is relatively low, the probability that any individual return will be audited is also relatively low. And even if the return is subjected to audit, as long as the taxpayer's interpretation of his or her rights is not obviously unreasonable, the only penalty is the payment of interest on unpaid taxes.

Anecdotes abound about taxpayers who, taking advantage of the flexibility that self-reporting of income offers, minimize their tax obligations or simply carry on activities "on the side" in the underground economy. Some popular perceptions refer to:

- those who have found a way to "write off" their car, or part of the cost of running their home against income from self-employment or a small business;
- those who enjoy the same standard of living as their friends or neighbours, yet pay only a small fraction of their tax load;
- those who avoid the tax system altogether, earning income and not reporting it, taking payments in cash or trading goods and services outside the regular market; or
- those who claim as business expenses expenditures that are obviously personal.

Precise information is much more difficult to find than anecdotes. Direct information from tax data is obviously not relevant because only net income from self employment after deductions is reported in the statistics.

Various studies have attempted to measure the extent of under-reporting of income for tax purposes and the size of the underground or cash economy. Interest in this area has increased in recent years because of the obvious incentive for tax avoidance created by the introduction of the federal Goods and Services Tax.

Studies have estimated the size of the underground economy in OECD countries to be between 4% and 30% of Gross Domestic Product (*Economist* 1987). If an estimate of 10% were used, a figure which is favoured by Mirus and Smith in their study covering 1972 to 1982 (1989, 290), then the total estimate of untaxed revenue would be $27.5 billion (10% multiplied by the GDP in 1991 which was $275 billion.) Estimates from the University of Toronto's economic model for Canada (the FOCUS model) show that total taxes collected by all levels of government rise 41 cents for

each dollar of GDP (Spiro 1993). Thus, the total tax revenue lost to all levels of government in Canada combined in a $27.5 billion underground economy would be approximately $11.3 billion in 1991.

As difficult as it is to measure the underground economy, it is even more difficult to conceive of mechanisms to bring it into the tax system.

One of the supposed advantages of the GST was that as a value-added tax, it would tax the inputs (goods and services used in production) used by people who operate in the underground economy and provide an incentive for them to report their activities in order to claim tax credits.

In fact, both anecdotal information and statistical estimates suggest that the effect has been the opposite – more activity has been driven into the underground economy by the creation of the GST. A recent study of the impact of the GST on the size of the underground economy estimates that increased underground economic activity since the introduction of the GST reduced measured consumer expenditure in 1992 by approximately $5.7 billion and produced total tax revenue losses of $2.3 billion shared among all levels of government in Canada (Spiro 1992).

Because income from economic activity can only be taxed if it is voluntarily reported, any enforcement response should reinforce people's belief in the probability that they will be caught. Changes in information technology offer the potential to increase our ability to attribute income back to individuals, but such changes would be at the expense of both personal privacy and the tradition of self-reporting that is basic to our income tax system.

With respect to controlling abuse of the provisions of the tax system by individuals who function "above ground" in the economy, there is a relatively simple choice. We can either continue to try to fine-tune the rules or accept as inevitable that it will not be possible to make the system work to deliver the pure results that were intended and adopt "rough justice" solutions.

In the 1980s, Canadian tax authorities began to rely more heavily on "rough justice" solutions to these types of problems. Rules governing the use of employer-provided automobiles, for example, now apply an arbitrary stand-by charge for personal use, instead of relying on taxpayer declarations.

In recent years, changes have been made to the income tax laws to make it more difficult to avoid paying taxes by generating losses from real estate and other investments and writing off those losses against other income. Rather than attempt to deal with abuse of the system by fine-tuning the rules applying to these types of income and the offsetting expenses, very broad rules were put in place to limit the value of these activities as tax shelters.

This approach could be expanded. For example, there could be limitations on the deductibility of losses from sideline activities. Deductions could be limited to a maximum of a certain percentage of income, provided there is some provision for carrying losses forward or backward between tax years.

Simplification of the tax system and the associated rules would also serve to limit tax avoidance. It is inevitable that as the system becomes more complex, opportunities expand for taxpayers to structure their affairs to avoid paying tax. Eliminating grey areas by adopting clear rules

makes abuse virtually impossible. For example, the British income tax system disallows business entertainment entirely as an expense in all cases except where the entertainment involves foreign clients.

Avoiding taxes – who's winning?

> *"... if someone else can get away with putting something over on the government and avoid paying some tax, it doesn't hurt me."*

Some people describe administering a tax system as a game of chess between the tax professionals who help taxpayers plan their affairs to minimize their taxes and the tax professionals who advise governments on how to plug up the holes in the system.

In a contest between an individual taxpayer and the government, it is hard to work up much sympathy for the tax collectors. It looks like a contest between a "little person" and a large, impersonal institution. Many of us wish we had the option of paying less tax, so our natural sympathy is with the taxpayer. After all, if the taxpayer wins the fight, at least someone is winning something, and there appears to be no loser.

The problem with tax avoidance schemes is that all of us are losers. The costs of running public services do not go down just because the tax system is "leaky." Everyone else's taxes have to go up to make up for the revenue that leaks out of the system.

The extent of the loss is very difficult to measure because there are no direct statistics available.

Sales tax

Sales taxes and fairness

> *"... there's nothing wrong with the sales tax; after all, everyone pays the same rate."*

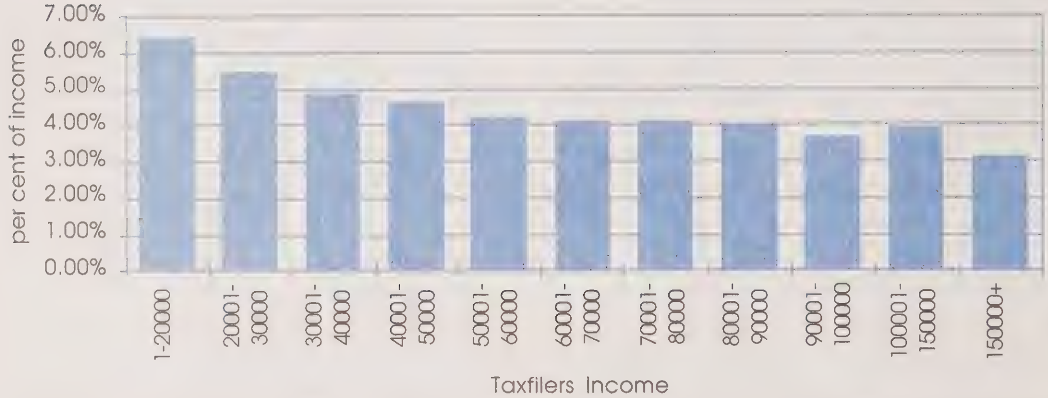
Everyone pays the same rate of sales tax. But because people's spending patterns differ, the impact of the tax is not the same on all households in Ontario. Lower- and middle-income households spend a much higher percentage of their incomes on taxable goods and services than households with higher incomes. As a result, the relative impact of a sales tax is more significant for low-income households than it is for higher-income households.

The proportion of a household's income that goes to sales taxes declines as household income increases, making the sales tax a regressive tax. Figure 31 shows the percentage of household income that is paid out in Ontario retail sales tax for each range of household income.

The figure reveals a regressive overall impact. The higher the income range, the lower the percentage of average household income in that range that is spent on retail sales tax.

Ontario's Retail Sales Tax (RST) is a general tax of 8% on final consumption, that is, it applies to goods and some services purchased at the retail level by consumers. The major exemptions are food, all forms of energy, children's clothing and shoes, and reading material.

FIGURE 31
IMPACT OF DIRECT AND INDIRECT RETAIL SALES TAX AS A PERCENTAGE OF INCOME, ONTARIO, 1991



Source: FTC calculations based on Statistics Canada Social Policy Simulation Database/Model (SPSD/M) and Family Expenditures Survey.

Raw materials, parts, and machinery used in manufacturing and processing are exempt. However, other taxable goods and services used as inputs in the production of goods and services are taxable. The sales tax paid by business on these inputs is included in the prices of the goods and services they sell. As a result, the actual amount of sales tax on some goods and services can end up being higher than the 8% rate that the customer pays at the cash register. It also means that some products that appear to be tax exempt actually include some RST in their prices.

About 59% of RST is paid by consumers directly. About 35% is paid initially by business on inputs used to produce goods and services, and eventually by consumers in the form of higher prices for those goods and services. And about 6% is paid initially by municipalities, universities, school boards and hospitals, and eventually by taxpayers through other taxes and fees (FTC tabulation based on data from Statistics Canada, Input Output Division).

The basic question in sales tax reform has to do with the role that this tax plays in the overall mix of taxes in Ontario. Some people argue that a regressive tax like the sales tax should not play a major role in our tax mix. They argue that significant sales taxes might be more acceptable in Europe, where the system of public services is much more comprehensive than it is in Canada. In effect, they argue, sales taxes place an unacceptable burden on the poor and moderate-income families, given Canada's relatively limited social service and social security system. Others argue that it would be impractical to eliminate the Retail Sales Tax because of the amount of money it raises. They also argue that it would accomplish little because even if the sales tax were eliminated, Ontarians would still pay a sales tax – the GST.

Beyond these more general concerns, three key policy questions must be addressed:

- Should business inputs be taxed?

- What should be exempted from the tax?
- How should the disproportionate impact of the RST on low-income families and individuals be dealt with?

Taxing business inputs

It has been argued that the removal of tax on business inputs will increase productivity through a decrease in the price of investment goods, such as machinery and equipment. While this might have been the case for the GST, it is less so for the Retail Sales Tax. Much of the RST on business inputs is on goods that are not investment related. Much of the RST paid on investment goods is paid on purchases of motor vehicles.

Because some business inputs are subject to tax, the percentage of the purchase price accounted for by sales tax varies depending on the type of good or service. Some products have substantial RST buried in their price because they include a high value of taxable inputs.

The prices of other products include little or no hidden RST because they do not include a lot of taxable inputs. As a result, the total amount of tax paid directly at the retail level and indirectly through the tax on product inputs will vary among different products and between similar products produced by different manufacturers.

Because it results in different tax rates applying to different types of products in essentially a random fashion, taxing business inputs introduces distortions into product prices that serve no public policy purpose. It also causes problems for Ontario producers who compete with imports or produce products for the export market. Ontario producers selling in export markets have Ontario sales taxes buried in their cost structure.

At the same time, it must be recognized that the Ontario sales tax on business inputs raises 35% of the revenue collected by the RST, or as estimated for 1992-93, about $2.75 billion. That lost revenue would have to be replaced. While in theory we would expect prices to drop by the amount of the reduced tax on inputs, thereby permitting the lost revenue to be recovered through higher rates with no increase in average prices including tax, there is no guarantee this would happen (FTC calculation based on data from Statistics Canada, Input Output Division).

The RST/GST Working Group of the Fair Tax Commission recommended that the sales tax be removed from all capital goods used by business (Fair Tax Commission 1992d).

Exemptions and the impact of the RST on the poor

The other major policy question that has to be answered concerns which products or consumers should be exempted from the tax. Exemptions complicate the administration of a sales tax. They can also influence decisions made by consumers and producers in the economy, giving them incentives to shift their consumption patterns away from taxed goods and services towards untaxed goods and services.

Because of these problems with sales tax exemptions, it is important that they serve some public policy purpose. In principle, an exemption from a sales tax should either make the tax fairer or provide a subsidy for a form of consumption or for consumers considered to merit public support.

"... taxing food would make the tax system fairer; after all, rich people spend more on food than poor people."

What impact do the current exemptions from Retail Sales Tax have on the fairness of the tax? Do these exemptions make the tax more regressive or less regressive than it would be without the exemption?

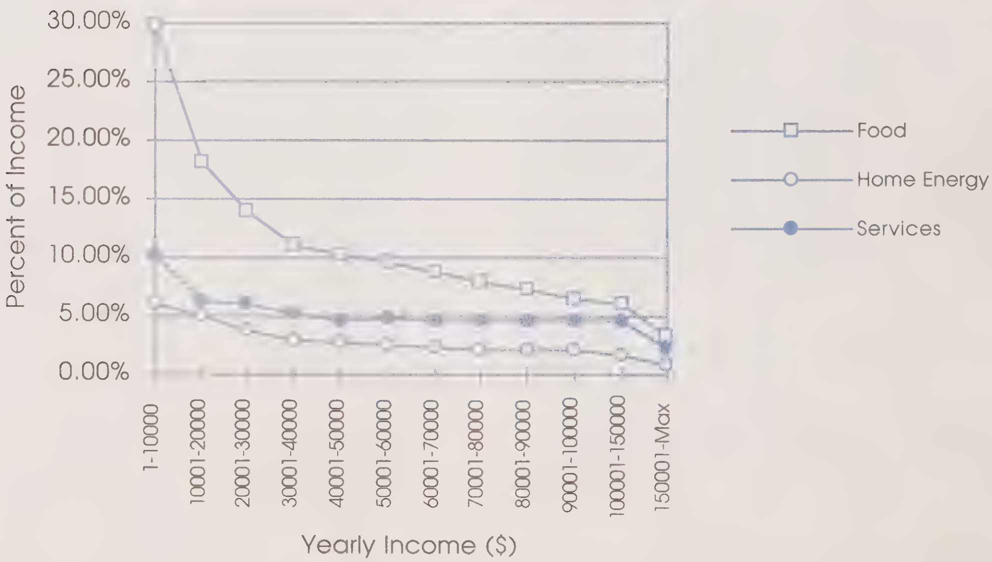
Data on the consumption of the main categories of products exempt from RST show that, with the exception of food, removing these products from the list of exemptions would have no noticeable effect on the overall impact of the tax on household incomes.

Figures 32 and 33 show the proportion of household income that is spent on the major expenditure items that are not currently subject to retail sales tax: food, home energy, services, prescription drugs, children's clothing and reading material.

With the exception of food, expenditures on these goods and services are less regressive in their impact than expenditures on goods and services that are subject to retail sales tax. Taxation of books would actually make the tax less regressive. Adding these goods and services to the list of goods subject to the retail sales tax would not make the RST appreciably more regressive. It is evident from these figures, however, that adding food to the RST base would in fact make the tax more regressive.

It is true that people with higher incomes spend more on food than poor people – higher-income households spend more on almost everything than lower-income households. But adding food to a sales tax base would increase the share of sales taxes paid by low-income households because low-income households spend proportionally more of their incomes on tax exempt food than higher-income households.

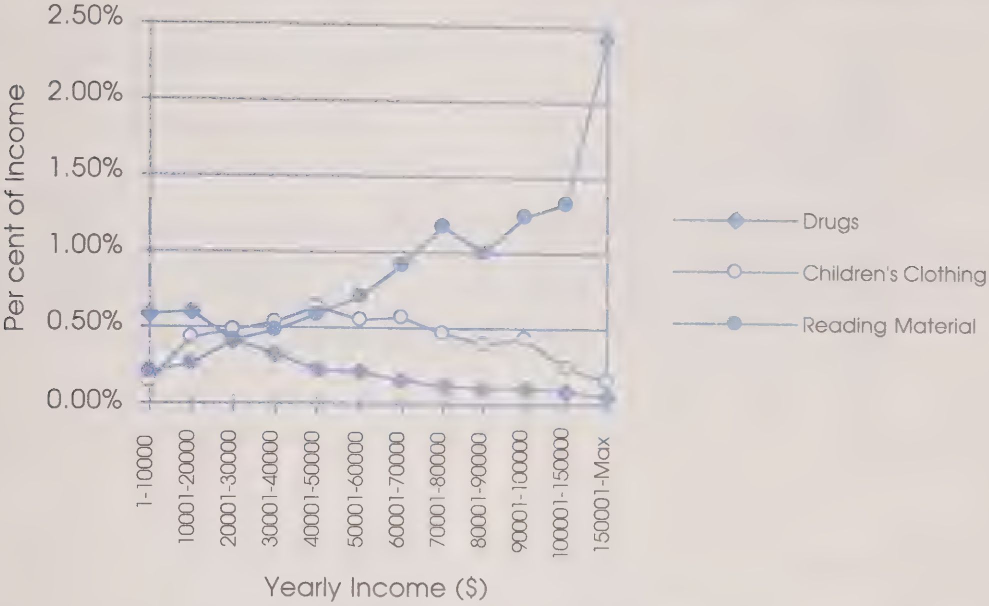
FIGURE 32
EXPENDITURES ON FOOD, HOME ENERGY AND SERVICES AS A SHARE OF INCOME, ONTARIO 1991



Source: FTC calculations based on Statistics Canada Social Policy Simulation Database/Model (SPSD/M) and Family Expenditures Survey.

FIGURE 33

EXPENDITURES ON PRESCRIPTION DRUGS, CHILDREN'S CLOTHING AND READING MATERIAL AS A SHARE OF INCOME, ONTARIO, 1991



Source: FTC calculations based on Statistics Canada Social Policy Simulation Database/Model (SPSD/M) and Family Expenditures Survey.

There are, of course, other reasons why certain products might be exempt from tax. For example, one might exempt food and energy for home heating and cooking because they are considered to be essential. Books and magazines are exempt presumably because governments want to promote literacy and/or the publishing industry. Children's clothing and shoes are exempt presumably because, quite apart from the impact of the tax on household incomes, the government wishes to reduce costs for families with children.

This analysis raises the question regarding the best way to promote these social policy objectives. For example, is a tax exemption for children's clothing the best way to help families with children?

RST and GST compared – a fairness audit

> *"... the retail sales tax in Ontario is fairer than the GST because the GST covers almost everything, while some goods and services are exempt from retail sales tax."*

Structurally, the Retail Sales Tax and the Goods and Services Tax are quite different. The RST is a tax on final sales. The GST is applied at each stage of production of a good or service on the value added in that stage. The GST is referred to as a "multi-stage" tax.

Business inputs are automatically free of tax because business operators get credit for the GST they pay on their inputs when they send the GST they collect from their

FIGURE 34
SHARE OF MONEY INCOME PAID IN RST AND GST BY INCOME CATEGORIES, ONTARIO, 1991

Source: FTC calculations based on Statistics Canada Social Policy Simulation Database/Model (SPSD/M).

customers to the federal government. In effect, when one pays the GST at a retail store, part of the money goes to the federal government and part of it compensates the store for the GST that it paid on its purchases of inputs.

Even though there are many exemptions from the RST, while only food and financial services are exempt from the GST, the taxes are quite similar in their overall impact on household incomes. The following figure estimates the average percentage of household income spent on the GST as compared with the RST. In terms of their impact on vertical equity, the taxes are equally regressive.

Although the taxes are evidently similar in their impact on households across income classes, there may be important differences in the impact of the two taxes within the same income range. To the extent that households in the same income range differ substantially in the proportion of their incomes that they spend on goods and services which are subject to the GST as compared to the proportion of their income that they spend on goods and services which are subject to the RST, the taxes will have different impacts on households in similar circumstances. For example, a household that spends a very high proportion of its income on goods and services which are subject to GST but not to RST will pay relatively less RST than a household that spends a relatively small proportion of its income on RST exempt goods and services.

To harmonize or not to harmonize – is that the question?

> *"... it's not fair that we have to pay the administrative costs of running two sales tax systems in Ontario, the Retail Sales Tax and the GST."*

> "... *harmonizing the Retail Sales Tax and the GST would significantly improve the overall efficiency of our economy.*"

The fundamental questions that must be resolved in sales tax reform concern the taxation of business inputs and exemptions from tax. This raises the administrative question of harmonization between the RST and the GST.

The Fair Tax Commission Working Group on Retail Sales Tax/Goods and Services Tax agreed on a series of recommendations that would have eliminated all of the exemptions for goods in the RST, except for food, making the list of RST exemptions for goods the same as the list of goods exemptions in the GST. However, the group did not recommend extending the RST to the same services covered by the GST. The group also recommended that a broader range of business inputs be exempted from the RST. The group was not able to agree on the question of common administration of the RST and the GST, or harmonization (Fair Tax Commission 1992d).

The working group recommended harmonization on goods only as a way to address the problem of cross-border shopping. This phenomenon, which hit its peak just before the value of the Canadian dollar began to fall in 1992, emerged as a major issue for Fair Tax Commission tax forces in border communities. Goods harmonization was supported to enable the federal government to collect the Ontario RST at the border along with the GST.

On the surface, the case for harmonization of the RST and the GST appears compelling. It would appear obvious that significant savings would result from common administration of the two taxes. However, other factors considerably complicate the decision.

First, the economic productivity gains associated with moving from the Retail Sales Tax to a GST-type tax are questionable. The Retail Sales Tax already exempts a significant range of business inputs, which limits any impact on exporters or on investment.

Second, the range of goods covered by the RST is much broader than the range of goods covered by the former Federal Sales Tax (manufacturers' sales tax) at the federal level. As a result, broadening the base of the RST to match the GST base would not result in nearly the tax rate reduction made possible by the replacement of the Federal Sales Tax.

Considering all of the impacts together, the RST/GST Working Group estimated that full harmonization would permit the Retail Sales Tax rate to drop by only one percentage point – to 7% – if revenue from the tax is to be maintained at its current level. This represents a significant decrease, but nothing like the drop from 13.5% to 7% when the Federal Sales Tax was replaced by the GST (simulation conducted by Institute for Policy Analysis, 1991, using Focus Ontario model).

More importantly, harmonization with the GST may not produce the administrative simplicity and cost savings the original advocates of a single national sales tax system had in mind. So far, each of the harmonization agreements between provinces and the federal government has been different. The result is that what is described as harmonization is really just replacing one patchwork quilt of tax systems with another.

A single national sales tax system may be the most desirable solution. But the current approach to harmonization, with different arrangements for each province, is unlikely to lead to that result. One alternative to maintaining the RST or harmonizing with the GST as it now stands would be for Ontario to negotiate with the federal government along with the other provinces for a uniform national sales tax system on the GST model. Ontario and other provinces could negotiate changes to the GST model designed to achieve other national objectives or address specific problems with the GST.

Benefits taxes, user charges and social cost taxes

Earmarking

> *"... the tax system would be fairer if more taxes, such as environmental taxes, were earmarked for particular programs."*

In recent years, earmarking of funds raised from particular taxes for specific government purposes has been advocated as a solution to a number of different issues in public spending and taxation. For example, governments have used earmarking to try to offset negative public reaction to new taxes. Ontario's initial move into the lottery business in the 1970s was explained by the government of the day by using earmarking-type arguments. This controversial move was justified partly on the basis that the revenue would be devoted entirely to non-essential public expenditures.

The Tire Tax and Commercial Concentration Tax introduced in the 1989 Ontario budget were justified by the government on the basis that they were required to pay for particular spending programs. For governments one of the advantages of earmarking, as illustrated by these examples, is the possibility that it may reduce resistance to new taxes.

The Fair Tax Commission's consultation program, through the tax forces, reveals significant dissatisfaction with taxes such as the tire tax, which are advocated as a way to raise money to solve public policy problems, but end up not being spent for the announced purpose.

The Working Group on Environment and Taxation supported earmarking of environmental taxes and noted a similar dissatisfaction with "earmarked" taxes such as the tire tax that disappear into general revenues (Fair Tax Commission 1992e).

Some groups in society advocate earmarking as a way of limiting the scope for future government spending by tying specific sources of revenue to specific spending programs, theoretically making it more difficult for governments to undertake new spending initiatives. The idea behind this basis for earmarking is that governments would have to ask for specific tax increases to increase spending on specific programs.

Other groups advocate earmarking for a totally opposite reason: to protect a certain level of funding for specific programs. Environmental groups, for example, argue that revenues from environmental taxes should be directed towards environmental programs, partially as a way to secure funding for these programs and partially to respond to criticism of environmental levies as "tax grabs" that serve no real environmental purpose.

Residents of Northern Ontario have long advocated a kind of regional earmarking given their view that Northern Ontario receives substantially less in benefits from government programs than it contributes in taxes. This issue has emerged repeatedly in the Fair Tax Commission's consultative work.

Another set of arguments sees earmarking as a way to impose taxes as an incentive to change corporate behaviour without having a dramatically negative effect on the overall competitive position of the economic sector affected. That way, earmarked funds raised from environmental taxes would be set aside for the economic sector from which they were raised in an effort to ease the transition to more environmentally sound practices.

Whatever the merits of earmarking may be from a political perspective, the fairness case for earmarking is strongest when there is a direct relationship between the tax paid by the taxpayer and the benefits received by the taxpayer from the programs paid for from the earmarked funds. The fairness case is weakest where there is no necessary relationship between the benefits received from the expenditure and the amount raised from the tax. In other words, the fairness case is stronger, the closer the tax is to a user fee or a benefits levy for the program or service funded, and the tighter the link is between revenues generated and the levels of expenditure on the earmarked program.

Many of these fairness issues can also be characterized as efficiency arguments in favour of earmarking. Revenues from benefits taxes or user fees provide the government with useful information about the level of service demanded by the community and may serve to limit spending to the amount of revenue from the earmarked tax.

Reliance on user fees to provide a close link between revenue and expenditures is not always appropriate, however. In some cases, not all of the benefits from a service will be attributable to the user. For example, public transit benefits the user of the transit system directly. But by reducing congestion on the roads, it also provides benefits to non-users. As a result, a user charge on transit use that recovered the full cost of the service from the users of the system would not be appropriate. On both fairness and efficiency grounds, it would be appropriate to provide a subsidy to transit users from non-users who benefit from reduced road congestion.

There are a number of problems with extending the concept of earmarking beyond taxes and programs that have a direct benefits relationship.

- Tying spending in one area to the revenue from a particular tax may produce a mismatch between revenues and needs. For example, consider the idea of earmarking tobacco taxes for health promotion. Reduced revenue from cigarette taxes does not necessarily mean that spending on health promotion should be reduced, yet formal earmarking could theoretically produce that result.

- Earmarking may result in either "too much" or "too little" being spent on the earmarked purpose. When lotteries were introduced in Ontario, the funds were directed towards a limited range of expenditures. This allocation created a funding bonanza in certain areas, for example, capital spending on community arenas at a time when spending in other areas was being constrained.

- If the tax is not the sole potential source of revenue for the earmarked purpose, earmarking will not necessarily increase funds for that purpose. If the earmarked revenue displaces general revenues as a source of funding for the designated service, the only result will be to have a particular label on a particular number of tax dollars. There appears to be a link between revenues and expenditures, but no additional revenues flow to the targeted program.

- If earmarking overrides regular expenditure program reviews, it may inhibit the flow of funds to priority areas because revenues are already allocated to earmarked purposes. This pitfall generally does not arise with earmarked benefit taxes because in this case, program expenditures are "automatically" determined by consumer demand.

The traditional discussion of earmarking takes place in the context of the relationship between taxes and benefits received by the taxpayer. It is argued that if the distribution of benefits from a public program among taxpayers sufficiently matches the distribution of payments from taxpayers, the tax may be considered a user fee or benefits tax and earmarking is appropriate. When the benefits from a public program are widely dispersed among all taxpayers and the distribution does not match the distribution of tax liabilities, earmarking is inappropriate.

A slightly different analysis is required when the tax in question is tied to taxpayer behaviour that imposes a cost on the rest of society. For example, Ontario's tire tax, which is not earmarked, could be seen as a fee charged to compensate society for the costs associated with the disposal of tires. In this case, the logic of the earmarking analysis described above might apply in reverse. In effect, earmarking serves to compensate for or offset the social costs associated with tire consumption. Similarly, earmarking of revenue from pollution taxes for programs aimed at reducing pollution or for environmental clean-up programs could be seen as compensating those who bear the social costs associated with pollution.

Environmental taxation

> "*... taxes should be used more as incentives for companies and consumers to reduce pollution levels and environmentally destructive activities.*"

Widespread public interest in the use of the tax system as an environmental policy instrument was reflected by the appointment of the Fair Tax Commission's Working Group on Environment and Taxation (Fair Tax Commission 1992e). The working group's reports strongly endorse the idea of using the tax system to discourage environmentally damaging activities and to encourage environmentally sustainable practices. At the same time, the working group concluded that a number of conditions should be attached both to the design of environmental taxes and to the use of the revenue raised from them.

- Environmental taxes should be a complement to, rather than a substitute for, environmental regulation.

- Behavioural change rather than raising revenue should be the primary goal of environmental taxes.

- Revenue raised from environmental taxes should be earmarked to advance

the environmental objectives of the tax, and to help ease the economic transition to more environmentally sound practices.

- The objective of environmental taxation should be to ensure that environmental costs are included in the price of goods and services.

- Environmental taxes should be imposed as directly as possible on the practices they seek to change.

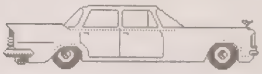
The working group recommended a pollution tax for Ontario that would apply to the discharge of certain pollutants into air or water, or onto land. The tax would increase with both the quantity of pollution and the risks associated with the particular pollutant. It also made other recommendations for measures that link environmental taxes to the social costs of the activity taxed.

For example, the group recommended that charges by the Ministry of Environment for certificates of approval for discharges into air and water be based on environmental impact rather than on the capital cost of the project that is subject to the charge. It also recommended taxes to discourage agricultural use of environmentally harmful pesticides.

One of the most talked-about areas for potential environmental taxation is the so-called "carbon tax." The idea behind a carbon tax is to provide incentives to reduce emissions of gases that contribute to global warming. The working group addressed the issue of using energy taxes as a means of reducing energy use and limiting carbon dioxide emissions.

A related study prepared for the FTC (Lazar and Donner 1992) considered the potential of energy taxes to encourage energy conservation. It reached the conclusion that the level of taxation required to produce substantial behavioural change would be so high that its impact would be potentially devastating to key industrial sectors in Ontario. The implications are that taxes may have to be established at low levels initially, followed by gradual increases over time and that revenues generated by these taxes should be fed back into the affected industries to neutralize the overall impact of the taxes.

Gasoline and fuel taxes – user charge or environmental tax?



Gasoline and fuel taxes are a significant source of revenue for Ontario, raising a total of approximately $2 billion in 1991-92. Since the energy crisis of the 1970s, the public rationale for these taxes has changed. Originally, gasoline and fuel taxes were seen as a way to recover from road users a portion of the costs of maintaining transportation infrastructure. Many of the exemptions from these taxes would appear to be designed to limit revenue-raising to fuel-related use of vehicles on public highways. For example, off-road uses of fuel on farms or in industry are exempt from tax. These exemptions may be at odds with more recent justifications for increases in fuel taxes on the basis that they encourage conservation of energy.

In effect, gasoline and fuel taxes are thought of as serving two quite different objectives: raising funds to support road construction and maintenance; and encouraging the conservation of energy. As a tax for road construction and maintenance, the current system raises questions concerning the strength of the link between

fuel consumption and the costs imposed by the user on the road system. As a tax for fuel conservation, the system raises questions concerning the appropriateness of exemptions for off-road transportation uses as well as commercial, industrial and residential heating and cooking uses.

Residents of Northern Ontario involved in Fair Tax Commission tax forces and others who wrote or sent submissions, also raised the issue of the level of fuel taxes in Ontario compared with those in the United States and the impact of the resulting price differences on cross-border shopping.

Other approaches to these issues may produce revenue sources that relate better to these two objectives. For example, a tax related to mileage driven and vehicle weight might be better related to road use and related maintenance cost than the current tax. A tax that applied to all fuel use – including off road transportation uses and cooking and heating uses – might be better targeted to encourage fuel conservation.

"Sin" taxes – behaviour change or cash cow?

Traditionally, taxes on cigarettes and alcohol have been advocated for their impact on limiting consumption of products considered harmful to human health. From the perspective of governments, they also have the advantage of being easy to raise without generating a great deal of public opposition. In 1991-92 tobacco taxes raised approximately $1 billion in revenue while LCBO profits and fees raised another $1 billion.

Until recently, these taxes have also been seen as attractive for a reason that directly contradicts their original intent – they have not affected consumption significantly and therefore are easy to raise without damaging the revenue base for the existing tax. Lately, however, the revenue base has been eroded by the increasingly widespread sale of illegally imported tobacco products in Ontario and by the reduction in consumption of alcohol and tobacco.

For taxes on alcohol and cigarettes in particular, there is a fundamental conflict between the government's revenue-raising objective and the stated rationale for the tax of encouraging a reduction in consumption. If the government succeeds in changing behaviour and reducing consumption, revenues will be reduced. On the other hand, rising revenues are a sign that the tax is failing in its objective of behavioural change.

When consumption declines and revenue drops, the government faces a dilemma. Does it increase the tax to maintain the revenue from the tax? Or does it set the tax based on its behavioural change objectives and let revenue simply be determined by the resulting levels of consumption?

User fees

> *"... the tax system would be fairer if more government services were paid for with fees charged to the users of the service."*

User charges have been advocated where a public service is similar to services delivered in the private sector in that the benefits associated with consuming the service are enjoyed primarily by the user of the service. For example, although there are clearly public benefits that flow from the

existence of public sewer and water services, given public health standards that govern all water for human consumption and all sewage disposal, the principal beneficiaries of sewer and water services are the direct users of the service.

The Property Tax Working Group of the Fair Tax Commission (Fair Tax Commission 1992c) recommended expansion of user charges for water and sewer services and suggested that volume or weight based charges for solid waste should be explored further.

User charges would not be considered appropriate where benefits are difficult to attribute to individual users. Reliance on user charges for only a portion of the costs of providing a service might be appropriate where a portion of the benefit from the use of a service accrues to people other than the direct user of the service. An example here would be to consider the benefits of improved public transportation to both car users in congested areas and to the direct users of public transit.

User charges are not appropriate where the purpose of the public program being funded is to provide a subsidy for the use of the service, to achieve a broader public purpose or explicitly to redistribute income or wealth.

Wealth taxes

"... taxing wealth would make Ontario's tax system more fair."

Data from the Fair Tax Commission's study of who pays taxes in Ontario indicate that taxes on the highest-income Ontarians actually decline as a proportion of income, as income increases (Block and Shillington 1993).

To the extent that fairness suggests the tax system should be at least proportional in its income impact if not consistently progressive, these data concerning the impact of the Ontario tax system pose a policy problem. One solution might be to attempt to tighten up the income tax system to increase the amount of revenue it raises from very high-income households.

An alternative might be to add a new tax to the mix of taxes in Ontario whose impact would be felt primarily by those with the greatest financial resources at their disposal. Data on the distribution of income and wealth also indicate that while both income and wealth are unequally distributed, wealth is much more concentrated in the hands of a few individuals than income.

In 1989, the wealthiest 5% of households received 14% of total income. The wealthiest 20% received 42% (FTC calculations using Statistics Canada 1990 survey of Consumer Finance microdata files). A study of wealth holdings in 1989 of Ontario households by Ernst & Young estimated that the wealthiest 5% of households held 46% of all household wealth and the wealthiest 20% held 74% of household wealth.

Analysis prepared for the Working Group on the Taxation of Wealth (Fair Tax Commission 1993b) identified the major arguments for and against wealth taxation as a way to enhance tax fairness. The most general argument advanced in favour of wealth taxation is that such a tax is necessary to fill gaps in the taxation of wealthy individuals that cannot reasonably be addressed through changes to the income tax system.

A related argument for wealth taxes on fairness grounds is that the current mix of taxes in Ontario includes a number of taxes that have a relatively greater impact on lower- and middle-income taxpayers who have little personal wealth, and that a tax that fell predominantly on higher-income and wealthy taxpayers would serve to re-balance the overall tax system.

Others who support wealth taxes on tax-fairness grounds argue that wealth constitutes a measure of ability to pay that is independent of the income of the holder of the wealth. Therefore, they argue, a tax on wealth would improve the overall fairness of the tax system.

Supporters of inheritance taxes on fairness grounds argue that an inheritance should essentially be treated the same way as other income and that there is no reason why it should be tax free while income earned from employment is taxed.

Those who oppose wealth taxes on fairness grounds argue that wealth is already heavily taxed in Canada, through a variety of taxes on assets of different kinds held by corporations and individuals. They argue, for example, that taxes such as the tax on capital gains, the corporate capital tax and probate fees charged on estates at death are all taxes on wealth.

Others argue that the taxation of wealth is a form of double taxation because the income that generates wealth in the first place is subject to tax when it is earned.

Opponents of wealth taxes raise concerns about the problem of liquidity associated with taxing assets rather than income, in that people might be required to sell assets in order to pay their taxes. Wealth tax opponents also argue that the imposition of new taxes on wealth would be self-destructive because wealthy individuals would leave the country to avoid tax. This would remove a source of capital from the economy as well as reduce the revenue raised from other taxes that would otherwise have been paid.

In addition to tax-fairness arguments, proponents of wealth taxes argue that, based on social equity grounds, wealth taxes can lessen inequalities in the distribution of wealth and help to equalize economic opportunities.

Some opponents of this view feel taxes in general and wealth taxes in particular cannot be effective in achieving these objectives. Others argue that the objective itself is inappropriate in that accumulations of wealth are justifiable as the individual's reward for hard work, saving and entrepreneurship.

Who would pay a wealth tax if we had one?

There are two quite distinct types of taxes on wealth that are levied in OECD countries. They are levied either alone or in combination with each other. Wealth transfer taxes tax a portion of the value of transfers of wealth between generations; annual net wealth taxes tax a relatively small percentage of net wealth each year.

Each type of tax typically exempts from taxation either certain types of wealth or all wealth up to a specified threshold amount. Although different arguments, pro and con, apply to each of these specific types of wealth taxes, the basic policy questions have to do with whether a new tax on wealth of any kind would be an appropriate addition to Ontario's mix of taxes, and if so, whether it is feasible to levy such a tax at the provincial level.

As the data on the distribution of wealth presented above suggest, taxes on wealth could be designed with exemptions high enough to limit the impact of the tax to a very small percentage of all households, while taxing a substantial proportion of total wealth.

For example, estimates prepared for the Working Group on the Taxation of Wealth show that an annual net wealth tax that included a household wealth exemption of $1 million would apply to only 6.3% of households in Ontario and still have a base of more than 30% of household wealth in the province (FTC calculation based on Ernst & Young 1990). A wealth transfer tax that applied to estates of $1 million or more (with a full exemption for transfers to spouses) would apply to only an estimated 1.6% of estates (FTC calculation based on Ernst & Young 1990; Statistics Canada 1986).

A smaller proportion of estates than of households' net wealth amounts to more than $1 million for two principal reasons. First, estates are individually based rather than household based. Second, individual estates represent net wealth at death. As a result, they tend to reflect the wealth holdings of elderly people. Because average net wealth declines after age 65, the value of large estates will tend to be smaller than the net wealth of the deceased person was earlier in his or her life.

Although estimated revenue from an Ontario wealth tax (net of administration costs) of anywhere from $500 million to $1 billion per year is a significant amount, it is not large in relation to total tax revenues. No country that has a wealth tax raises a significant proportion of its total budget from such a tax. There is no reason to expect that Ontario's experience would be significantly different.

Canada as a tax haven

> "*... imposing any kind of tax on wealth would put Canada and Ontario out of step with this country's major competitors.*"

Canada, Australia, and New Zealand (which abolished its estate duty in December, 1992) are the only countries in the OECD that do not levy taxes on wealth. Every other country levies one or more of an annual tax on net wealth or a wealth transfer tax involving some combination of a gift tax, an inheritance tax (a tax on inheritors of wealth) and/or an estate tax (a tax on the estate of a deceased person).

Although there are no wealth taxes in Canada at present, such taxes have a long history in this country. About 100 years ago, the province of Ontario was among the first, along with New Brunswick, to introduce a tax on wealth in the form of an inheritance tax, modelled on taxes then in effect in New York and Pennsylvania.

Wealth taxes were not introduced at the national level until 1941, when the federal government introduced a succession duty. The national estate tax continued in effect until 1972 when it was repealed. In 1979, Ontario abolished its succession duty. In 1985, Quebec abolished the last provincial succession duty in Canada.

Although wealth taxes are common in most OECD countries, in most the tax raises a relatively small proportion of total tax revenue – in the range of 0.5% to 2%. Table 5 shows the percentage of total tax revenue raised from taxes on wealth (inheritance, gift and estate taxes and annual net wealth taxes) in all OECD countries.

TABLE 5
TOTAL REVENUE FROM WEALTH TAX AS A PERCENTAGE OF TOTAL TAX REVENUE FOR OECD COUNTRIES, 1990

Switzerland	3.21%	Belgium	0.69%
Iceland	1.50%	Austria	0.57%
Japan	1.41%	Luxembourg	0.64%
Norway	1.32%	Germany	0.64%
Greece	1.26%	Finland	0.51%
France	1.17%	Portugal	0.50%
Spain	1.04%	Ireland	0.40%
Netherlands	1.03%	New Zealand	0.29%
United States	0.96%	Italy	0.14%
Denmark	0.81%	Turkey	0.12%
Sweden	0.60%	Australia	0.00%
United Kingdom	0.65%	Canada	0.00%

Source: OECD 1992a, *Revenue Statistics.*
Note: New Zealand abolished its estate duty in December, 1992.

Would a wealth tax be practical for Ontario?

> *"... even if we wanted to use a wealth tax to improve the fairness of Ontario's tax system, it would be too easy for wealthy people to avoid."*

Setting aside the question of the desirability of taxes on wealth, there are issues of viability at the national as well as at the sub-national level. Because many of the assets that should be included in the base for a wealth tax are very mobile, it is very difficult to prevent avoidance of wealth taxes.

Perhaps more importantly, if concentrations of wealth are moved to avoid wealth taxes, it is argued that less capital may be available for economic growth. If the owners of the wealth also move, the revenue from other taxes they might otherwise have paid will also be lost.

These concerns are all the more pressing when considering the implementation of wealth taxes at the provincial level. The movement of assets and people to avoid taxes is easier between provinces within Canada than it is between Canada and other national jurisdictions. Canadian experience suggests that this could be a problem.

In the 1970s, competition among provinces was one of a number of factors contributing to the elimination of provincial succession duties.

Corporate income tax

What corporate tax share is fair?

> *"... if we just made sure that corporations paid their fair share of tax, the tax system would be fairer."*

Corporate tax revenue varies significantly from year to year because corporate profits are so sensitive to the business cycle. However, since the 1950s there has been a steady downward trend in corporate income taxes as a percentage of total provincial revenue, with capital tax revenue remaining relatively constant. (The capital tax is a tax on the total amount of capital employed in a business in Ontario. The capital tax base includes paid-up corporate capital and the long-term borrowing of the corporation).

Although it is clear from the historical data that the corporate sector's share of total provincial revenue has declined over time, much of that decline is the result of the growth of total provincial revenues relative to the economy and the decline in corporate profits relative to the size of the economy. A better picture can be

provided by comparing the trend in corporate profits as a percentage of Gross Provincial Product (GPP – the total output of the provincial economy) with the trend in provincial corporate income and capital taxes as a percentage of GPP.

Since 1970, Ontario's revenue from corporate income taxes has varied as a percentage of GPP with the business cycle, rising in relative terms during periods of prosperity and declining during recessions. Over that period, there is no evident trend, either upwards or downwards. In the same period, OECD data for Canada suggest that federal and provincial corporate income taxes combined have declined relative to Canada's output of goods and services – the Gross Domestic Product (GDP), dropping from 3.5% in 1970 to 3% and less in the late 1980s. Increases in tax rates at the provincial level would appear to have kept Ontario's corporate income taxes at a consistent proportion of provincial product while reductions in federal corporate income taxes have caused the combined total to trend downwards (OECD 1992a).

The apparent inconsistency in these trends suggests that a substantial proportion of the decline in corporate profits taxes as a proportion of GDP is the result of a reduction in the share of profits in GDP over that period. This downward trend at the national level differs from the experience of the countries of the European Economic Community. From 1965 to 1990, taxes on corporate income in Canada declined from 3.9% of GDP to 2.5% of GDP, while the average for EEC countries actually increased from 2.0% of GDP to 3.1% of GDP (OECD 1992a).

The trend for the United States over the same period was similar to that for Canada, showing a decline from 4.1% of GDP in 1965 to 2.2% in 1990. The corporate tax levels necessary to restore total corporate income tax revenue to previous levels would push Canadian corporate income taxes significantly above those in the United States.

While the impact of corporate taxation on investment decisions and the low effective tax rate paid by some profitable corporations tend to dominate discussions of corporate tax policy, there is another issue of some importance. For corporations paying effective rates of tax close to the official rates, as a percentage of the profits they report to their shareholders, there may be substantial pressure to report income in lower tax rate jurisdictions in order to minimize corporate tax on a global basis.

In the case of companies that are part of larger corporate groups, this can occur in a variety of ways. While intra-company pricing practices (the price at which goods are sold between members of the corporate group) and charges for intangibles such as research and development are frequently mentioned, other practices such as varying the locations from which funds are borrowed and interest deductions are made, are also important.

Given the globalization of the economy and the complexity of business relationships and practices, there is little chance that a single government jurisdiction can deal effectively with these pressures. The importance of this is that it may make it counter-productive – even from a revenue perspective – for a government to attempt

to raise tax rates beyond a certain point, as it will create pressure for firms paying tax at full rates to reorganize their affairs to be subject to tax in a lower tax jurisdiction.

Because of the increased flexibility that corporations have in structuring their affairs to minimize tax on an international basis, it may no longer be possible for any one jurisdiction to exercise any meaningful control over the reporting of corporate profits. The European Economic Community (EEC) is attempting to address the problems created for tax authorities by capital and goods mobility through establishing EEC-wide standards for corporate taxation. It may be that similar action on an international level is necessary to protect the corporate tax bases of individual countries, particularly where trade barriers are lowered as they are between Canada and the United States, and may soon be among Canada, the United States and Mexico.

Does it matter how much we tax corporations?

> *"... corporations don't pay taxes, people do."*

If this is true, why do we tax corporations at all? Why not just tax people?

Even if one accepts the proposition that, ultimately, taxes are not paid by corporations but are paid by the people who buy from them, the people who work for them, and the people who own them or provide them with capital, there are several reasons for levying taxes on corporations.

First, it is sometimes difficult to draw a line between corporations and the people who own them. A failure to tax personal corporations (corporations with only one shareholder) might effectively leave substantial amounts of income untaxed.

Second, taxing corporations allows the public to influence the timing of tax payments on corporate profits. Without a corporate tax, no revenue would be generated from profits until they are eventually paid out to shareholders as dividends or realized by shareholders as capital gains.

Third, taxing corporations is a simple and straightforward way to tax non-resident owners of corporations. This basis for corporate taxation is particularly important in a country like Canada, where such a large proportion of the private economy is foreign-owned.

In serving these objectives, the corporate income tax acts as a withholding tax, in effect collecting tax on shareholders' income before it is actually paid out to them. Such a tax is designed to tax income that belongs to shareholders but is not actually received by them.

This basis for corporate taxation supports the idea that the tax system should give credit for taxes already paid on corporate income in determining the amount of tax to be paid by shareholders on dividend income. The Canadian dividend tax credit is designed in part for this purpose.

Rates and revenue

Ontario, Alberta and Quebec are the only provinces that levy their own corporate income taxes. All other provinces levy corporate taxes through tax collection agreements with the federal government similar to those for the personal income tax.

Although Ontario levies its own tax, the tax is based on essentially the same definition of corporate income as the federal corporate income tax and allows essentially the same deductions. The Ontario and federal governments apply different rates of corporate taxes on various categories of business taxpayers. Ontario also provides some tax deductions and credits that are more generous than those provided in the federal corporate tax statutes.

The schedule of tax rates on various types of businesses in Ontario is as follows:

TABLE 6
CORPORATE INCOME TAX RATES, ONTARIO AND COMBINED FEDERAL AND ONTARIO, INCLUDING 1992 BUDGET CHANGES

	Eligible for Small Business Deduction	M&P* Income	Other Income
Ontario			
Before May 1, 1992	10%	14.5%	15.5%
May 1, 1992 to December 31, 1992	9.5%	14.5%	15.5%
After December 31, 1992	9.5%	13.5%	15.5%
Combined Federal/Ontario**			
After December 31, 1992	22.34%	36.34%	44.34%
After December 31, 1993	22.34%	35.34%	44.34%

* M&P means manufacturing and processing.
** Includes the 3% federal surtax. This is calculated on the general rate of 28% before the manufacturing and processing and the small business deduction. It equals 0.84% when converted to the equivalent tax rate.

Source: FTC calculations based on CCH *1993 Canadian Master Tax Guide.*

The benefits from Ontario's preferential tax rate on small business are recaptured from larger businesses through the application of a surcharge on profits over $200,000. Although these tax rates are the rates that apply nominally to the profits of corporations, a study of 1987 profits done for the Fair Tax Commission by Statistics Canada (Sabourin, Gribble, and Wolfson 1992) shows that the actual or effective rate of tax paid on corporate profits in Ontario is substantially below these nominal rates.

Effective corporate tax rates for economically profitable Ontario corporations in 1987 varied according to the size of the corporation and the industrial sector in which the corporation predominantly operated. Effective Ontario rates of tax were highest for manufacturing (10.2%), construction (10.4%) and services (11.9%) and lowest for the resource sector (5.6%) and financial services sector (4.2%). Effective rates of Ontario corporate tax tended to increase as the asset size of the corporation increased.

Since 1987, federal corporate tax reform has eliminated or limited a number of the special tax provisions that serve to reduce effective rates of corporate tax. The changes in tax provisions may have affected the level of, and variation in, effective tax rates by size of corporation and across industrial groups. More current data sources are needed to investigate these possibilities. However, many special tax provisions remain. Their estimated impact on the tax system are discussed in the next section.

Corporate taxes and economic policy

> *"... tax breaks or incentives go to corporations and there's no accountability or follow through."*

> *"... the economy is changing a lot – are we still giving incentives for the right things?"*

The corporate tax system in Ontario provides special treatment to various types of corporations in the form of reduced rates of tax, credits and deductions. Table 7 summarizes these special provisions and their impact on corporate income tax revenue.

The impact on the tax system as a whole of these special provisions on provincial revenues from corporate income taxes is substantial. The existence of these special provisions in the tax system is also the major reason why profitable corporations can pay little or no corporate income tax.

As corporate tax expenditures are now structured, manufacturing and processing businesses qualify for greater benefits than service-producing businesses. Similarly, corporate tax expenditures tend to benefit investments in new physical capital such as machinery and equipment, as opposed to investments in human capital or in improving the way capital is used. Corporate tax expenditures share the same problems as personal income tax expenditures – they are hidden from view and escape the kinds of budgetary controls and scrutiny to which expenditure programs such as direct grants or loans would normally be subjected.

The structure of the incentives currently contained in the corporate tax system raises important policy questions.

TABLE 7
CORPORATE TAX EXPENDITURE ESTIMATES, ONTARIO 1991-92
($MILLION)

Corporate Income Tax[1]	**Ontario Revenue Foregone**
Capital Cost Allowance vs Accounting Depreciation	460
Capital Gains Exclusion	300
Reduced Rate for for Specified Sectors	502
Current Cost Adjustment	752
Research and Development Super Allowance	502
Exploration and Development Expenses	175
Resource Allowance	25
Small Business Development Corporations Program	*
Charitable Donations	45
Small Business Deduction	380
Capital Tax	
Flat Capital Tax for Small Business	1203
Employer Health Tax	
Reduced Rates for Small Employers	150§

* Less than $5 million.
1 These estimates are based on a detailed federal sample of corporations with taxable income allocated to Ontario.
2 Special tabulation based on Ontario Ministry of Finance data.
3 These taxes are deductible from corporate income taxes. Therefore the cost of the tax expenditure is overstated in these estimates.
§ 1990 figure.

Source: Fair Tax Commission 1993a, "Ontario Tax Expenditures."

- Current thinking suggests that the education, training and skills of the workforce are the critical factors in determining a country's relative economic performance. If this is true, does it make sense to offer tax incentives only for investments in physical capital?

- Are tax incentives effective in achieving their policy objectives? There is some evidence, for example, that despite very generous provisions for Research and Development (R&D) in both the federal and provincial corporate income taxes, Ontario's and Canada's performance lag behind that of many other OECD countries.

- If we are going to continue to use the tax system to deliver economic incentives to business, shouldn't the revenue foregone be accounted for and the effectiveness of the incentives evaluated so that we can determine whether or not we are getting the corporate behaviour we want for the tax money we are giving up?

Minimum taxes

> *"... it's not fair that some profitable corporations can get away without paying any tax."*

Data from 1989, prepared for the Working Group on Corporate Minimum Tax (Fair Tax Commission 1992a), suggest that even with federal tax reform, some profitable corporations continue to pay little or no income tax.

An analysis of corporate tax administrative data for 1989 conducted for the working group found that in 1989, 13% of all Ontario corporations (23,300 corporations) reported profits and paid no corporate income tax and a further estimated 3% of Ontario corporations (6000 corporations) paid tax at an effective rate of less than 5% of Ontario book profits (profits reported to shareholders). Of the roughly $53 billion in profits earned by profitable corporations, $18.5 billion was earned by companies that paid no Ontario income tax in 1989. A further estimated $5 billion was earned by corporations that paid Ontario income tax in 1989 at an effective rate of less than 5% of book profits.

Of the $18.5 billion in profits earned by the 23,300 profitable corporations which paid no Ontario income tax, $700 million was non-taxable because of a tax holiday for new small businesses in 1989. Roughly 12,800 corporations took advantage of the tax holiday. The other 10,500 non-taxpaying corporations took advantage of a variety of deductions. $9 billion was non-taxable because dividends paid by one corporation to another corporation are not taxed. At least $850 million was equity income which is taxed at the subsidiary level. A further $2 billion was untaxed because losses from prior years may be deducted from current taxable income. The working group reviewed these deductions and concluded that it would be appropriate to permit them in the design of a minimum tax.

This left approximately $6 billion in profits that were non-taxable as a result of other deductions. Of this $6 billion in non-taxable profits, approximately $3.3 billion would have been allocated to Ontario for corporate tax purposes.

To gain some insights into the reasons why these remaining corporations paid no tax, the working group investigated in more detail the taxes and book profits of a sample of 144 companies that paid no Ontario income tax in 1989. The results of that further analysis are presented in figure 35.

FIGURE 35
MAJOR DEDUCTIONS WHICH ACCOUNT FOR 144 COMPANIES IN ONTARIO PAYING NO INCOME TAX

Notes:
Rollovers and Accounting Gains - "Paper gains" on corporate rollovers - Gains that are recognized for accounting purposes but are not recognized for tax purposes on tax-free inter-corporate reorganizations in which assets are transferred between members of the same corporate group without any economic gain or loss to the group.
Net Reserves - Amounts deducted from income to reflect various contingencies. Examples of deductible reserves include reserves for debts that may not be repaid, reserves for amounts not due until a later year, reserves for undelivered goods or unrendered services.
Other - This category includes "soft costs" and Ontario Current Cost Adjustment, pension adjustments, deferred charges, asset write-offs, plant closure and restructuring costs – price support, deferred tax adjustments and miscellaneous other items. (Prior to tax reform, "soft costs" [for example, interest, accounting and legal fees, insurance and property taxes] attributable to a period of construction or renovation of a building, could be fully deducted in the year the costs were incurred. Tax reform imposed restrictions on the deductibility of "soft costs.")
Source: Ontario Ministry of Revenue, Provincial Tax Administration Database (PTAD).

The above deduction items constitute the major reasons (after adjusting for equity income, inter-corporate dividends, prior years' losses and the small business tax holiday) that explain why profitable corporations may pay little or no income tax.

The major contributors to non-taxpaying status were capital cost allowances (depreciation for tax purposes) in excess of the actual depreciation shown on the corporation's books (41% of the deductions which account for companies paying no income tax), accrued gains on assets which are reported as book income but are not taxable until realized (23%), resource deductions (11%), the exclusion of 25% of capital gains from income (8%) and the Ontario Research and Development Super Allowance (5%).

Because of the role of tax expenditures in making it possible for profitable corporations to pay little or no tax, it is often argued that rather than impose a minimum tax to correct the problem, governments should simply eliminate economic incentives in the tax system. Alternatively, it is also argued that if governments think it is worthwhile to offer economic incentives in the tax system, they should not be concerned if corporations take advantage of them, even if it entirely eliminates their tax liability.

On the other hand, it is argued that regardless of the use of the tax system to deliver incentives, the role of the corporate tax as a withholding tax on shareholders' income requires that corporations pay at least some corporate tax. It is also argued that even if society wishes to continue to provide all of the tax breaks, it did not intend to create tax provisions to eliminate entirely the tax liability of profitable corporations. Several options are available to address this issue:

- A special corporate minimum tax based on income. The base for this tax would be broader than that of the regular corporate tax in that it would not allow some of the deductions and credits currently permitted.
- A tax on the distribution of dividends by corporations to shareholders.
- A modification of the existing corporate capital tax to make it more sensitive to the profitability of corporations.

The Corporate Minimum Tax Working Group considered all three of these options. Members agreed that a corporate minimum tax based on adjusted income would best address the problem of companies paying little or no income tax, but they were unable to identify a design that was both fair and practical. Some members viewed a tax on dividends distributed to shareholders as fair, but concluded that this option could be applied practically only at the federal level. The members of the group agreed that a capital-based option seemed to be more advantageous in terms of simplicity, practicality, and the ability of the tax to raise revenue.

This raises a number of key questions. Should there be a minimum tax on corporate profits? If so, what form should it take? And if the preferred form is one that can only be applied at the federal level, should Ontario proceed with a second-best solution, or should the issue be left at the federal level? And what is the second-best solution?

Small business taxes

All businesses in Ontario are responsible for remitting a wide variety of different taxes to the government. For some of these taxes – RST, GST, gasoline, motor vehicle fuel, and so on – the business acts as the collection agency for taxes that are the legal obligation of consumers. Some are employment-related, including workers' compensation levies, the Employer Health Tax, unemployment insurance premiums and Canada Pension Plan contributions. Others are taxes on assets used in business and include provincial capital tax and local non-residential property and business occupancy taxes.

While these taxes apply to all businesses, they raise particular issues as they are applied to small business. First, they raise questions about overall economic impact, given the importance attributed by many analysts to small business as an engine of growth in the economy. Second, they raise questions concerning the cumulative effect of these taxes on the ability of individual small businesses to get started and survive economic fluctuations. Third, they raise questions about the administrative burden imposed on businesses which must pay relatively small amounts of each of a large number of taxes.

In response to these concerns, virtually every tax levied on corporations includes a

special provision for small businesses, whether it is a lower rate or some other concession. These provisions include:

- A $500,000 lifetime capital-gains exemption in the personal income tax for sale of stock in a small business corporation (the exemption for other assets is $100,000).
- The lower small business tax rate and other special provisions in the corporate income tax.
- Full exemption or preferential rates for small business in the capital tax.
- The graduated rate structure in the employer health tax.

These and other special provisions included in the various tax statutes are intended to support small business activity as an important engine of economic growth, to encourage individual risk-taking and to compensate small business operators for costs and biases they face in the tax system and elsewhere.

The creation of special categories in taxes raises a series of challenging issues.

- To ensure that the right activities and businesses are supported, how do we define a small business?
- How can we be sure that we are providing the right amount of tax assistance, given that such assistance is provided in virtually every tax paid by the business sector?
- How should the tax provisions facing the incorporated small business sector be related to the tax provisions applicable to forms such as proprietorships or partnerships carrying on similar activities?
- Why is it that an individual earning $200,000 a year is considered to be wealthy and able to afford to bear a proportionately higher tax load, while a small business corporation with profits of $200,000 a year, owned by a single owner-manager, is considered to be deserving of special tax assistance when the income is retained in the corporation?

Payroll tax

Payroll taxes are a relatively recent addition to the mix of taxes contributing to government revenues in Ontario. An example is the Employer Health Tax (EHT), which came into effect in 1990 and replaced OHIP (health insurance) premiums.

In recent years, there has been considerable discussion of the potential for payroll taxes in general, particularly as a source of revenue for employment-related programs such as training.

Payroll taxes have also been suggested as a possible alternative to the local business occupancy tax, which is a form of property tax on business operators. One of the reasons for the interest is that it is one tax area where it appears Canadian tax levels are lower than they are in competing jurisdictions. Even after federal payroll taxes (UI premiums and CPP contributions) are taken into account, payroll taxes in total in Canada are lower than they are in other jurisdictions in the OECD.

The rate schedule of Ontario's EHT is as follows: 0.98% for employers with payrolls up to $200,000 a year and 1.95% for payrolls above $400,000 a year; with a graduated rate structure for payrolls between $200,000 and $400,000.

The split rate feature of the Ontario EHT is unusual for a payroll tax. None of the other payroll taxes paid by Ontario employers offer concessionary rates at low levels of total payroll. Since the tax is actually a tax on labour income, it would appear difficult to justify a feature of the system that makes the rate of tax paid on a given employee's income dependent on the total amount that is paid to other employees of the same employer.

In the 1992 Ontario Budget, self-employed individuals were made subject to the tax effective for taxation years ending after December 31, 1992. The rate paid is based on net self-employment income, but in calculating the tax, the first $40,000 of income is free of tax.

This broadening of the base of the tax has generated controversy on two grounds. First, it is argued that if the intention of the change is to ensure that everyone contributes to the funding of the health care system on the same basis, by including income from self-employment but not investment income, it discriminates in favour of individuals who derive their income from investment. Second, it is argued that the application of the tax to income from self-employment discriminates against self-employed professionals who cannot carry on their activities through incorporated businesses. Unlike the situation for other self-employed individuals, professionals are not able to deduct the tax for income tax purposes. Thus, it is argued, they are effectively taxed at much higher rates. In addition, self-employed professionals are not in a position to divide their income between wages and salaries, which are subject to EHT, and dividends which are not.

Although the tax applies to all employers and self-employed individuals, 82.5% of the revenue from the tax comes from employers with payrolls in excess of $1 million. More than 50% of EHT revenue comes from employers of more than 500 people and only 9.1% from employers of fewer than 20 people.

The major concerns about payroll taxes relate to their incidence – who actually pays the taxes – and their impact on the economy. In the longer term, the operation of the labour market would suggest that new or increased payroll taxes will eventually be absorbed by workers in the form of lower wages.

A paper prepared for the Fair Tax Commission estimated that about 90% of the burden of the Employer Health Tax is ultimately borne by labour (Dahlby 1993, 27). Using a similar tax shifting assumption, the FTC incidence study found that payroll taxes such as Ontario's, which applies to all wage and salary income with no maximum, are progressive through the middle-income range and regressive above middle-income levels.

The impact of payroll taxes on employment also raises concerns. In the short term, where employers have to pay a new or increased payroll tax in addition to wages, such a tax would be equivalent to a wage increase. It could also reduce total employment, with this impact gradually disappearing as the tax is absorbed by workers in the form of lower wage increases.

The length of time required for this adjustment is a matter of considerable debate in Canada. The traditional view is that these adjustments take place over a relatively short period of time. More recently, some economists have argued that the dramatic pace and scope of

the 1990s economic restructuring mean that any reduction in employment taking place now is much more likely to be permanent, because those who are displaced from existing jobs will find it difficult to find new jobs that they can perform (Dahlby 1993).

In evaluating the impact of increased reliance on payroll taxes, one of the important considerations is: What is the alternative? The negative impact of an increase in payroll taxes has to be offset against whatever gains might be realized from a reduction in another tax for which it might be a substitute. Those gains will vary depending on what alternative tax is the basis for comparison. For example, the impact will be quite different if the alternative were a sales tax than it would be if the alternative were a property tax.

Resource taxes

Taxes on natural resources differ from other taxes in that their rationale is not based on the need to raise revenue. In principle, the purpose of taxes on natural resources is to recover the value of natural products held in common for the benefit of society as a whole, but converted from the raw state into marketable products in the private economy.

Therefore, from a public policy perspective, a natural resource tax is fair if it recovers for the public a fair share of the value of the resource. For natural resources taxes, the objective in designing the tax is first to determine the value of the public resource and second, to determine what share of its value should be recovered by the public in the form of a tax.

This analysis leads to a number of general propositions that are relevant in the design of natural resource taxes and in establishing their relationship to other taxes.

First, the calculation of the value of the resource should vary with the price of the product and the costs associated with bringing it to market. In principle, the full cost of extraction and processing should include the return that the assets used for that purpose would earn in an alternative use.

Second, the costs associated with transforming the resource into a marketable product should include social costs that are incurred in the transformation process. These costs should be recovered from the operator. For example, the costs associated with site rehabilitation, forest regeneration or the loss of alternative uses of the resource base should be removed from the resource value base for resource tax purposes, and recovered through a separate charge.

Third, a resource tax designed to determine a "price" to be paid for the resource should be fully deductible from corporate income taxes as a business expense, in the same way as the price of any other business input is deductible.

Mining

The Mining Tax in Ontario is levied at a rate of 20% of mining profits. The mining profits base is the gross revenue from the sale of mine production less the costs incurred by the operator in exploration and development, production, processing and transportation. The cost base does not include any allowance for a normal profit on the assets used in the mining and processing operation. Instead, there is an allowance against mining profits for processing.

Beyond the basic tax structure, there are exemptions for the first $500,000 in mining profits each year and a three-year exemption from tax for new, significantly expanded and rehabilitated mines. The value of each of these major deductions from the mining tax base is as follows (tabulation from estimates based on 1991 data by the Taxation Policy Branch, Ontario Ministry of Finance):

• $500,000 exemption	$2 million
• 3-year tax holiday	$10 million *
• Processing allowance	$40 million *

* *Rounded to nearest $5 million.*

The design of a tax on mineral rents must reflect considerations of inter-jurisdictional competitiveness. The initial objective in the design of the mining tax is to establish the basis for determining a value that is the equivalent of a price for the resource itself, as distinct from the value of a product made from the resource.

Having determined the basis for valuing the resource, government must also be concerned about how the value of the resource that remains in the hands of the mining operator after paying Ontario's "price" compares with the value that remains in the hands of mining companies after paying the "price" in other jurisdictions that are sources of the same mineral product.

In addition to the Mining Tax, mine operators in Ontario also pay corporate income taxes and local property taxes on the same basis as other businesses. Important issues also arise with respect to the treatment of mining in the design of these other taxes.

Although in principle a tax on resource rents should be seen as a "price" for the mineral product being extracted, Ontario's mining tax is not recognized as a deductible expense in the corporate income tax.

Communities in Northern Ontario in which resource extraction and processing is the most important economic activity raise concerns about the assessment of mining properties and about the ability of the property tax to provide a fair share to the local community of the economic benefits from the presence of resource industries. In the current system, the assessed value of a resource property is based only on the value of the surface rights to the land and the buildings associated with the operation. The value excludes most of the machinery used in mining and mineral processing as well as the value of the mineral rights themselves. As a result, often only a small fraction of the evident value of the operation is included in its assessed value. Similar issues arise with respect to some forestry operations.

To address this issue, two suggestions have been put forward: reform the assessment system; and develop a broader system for the sharing of all tax revenues from resource operations. With respect to assessment, it has been suggested that the value of resource rights and immobile machinery and equipment located either on the surface or underground be included in determining the assessed value of a property. With respect to revenue sharing, proposals have been made for the earmarking of taxes generated by resource industries in Northern Ontario for the support of local public services.

Forestry

Ontario levies two types of forestry taxes. The Crown Royalty is a volume-based levy on a sliding scale based on the type of product and operator (higher rates for higher value products harvested by producers who both harvest and process; lower rates for lower value products harvested by companies that are involved only in harvesting.) The licence fee is based on the area of Crown land licensed for forest production.

In the framework set out above, the licence fee could be seen as a fee based on the costs incurred by the public for the occupancy of the site for forestry purposes. Therefore, in principle, the licence fee should bear some relationship to the public costs from loss of the forest to other uses such as tourism and recreation.

In addition, when determining the value of the forest resource or "rent" for taxation purposes, the costs to the public associated with sustaining renewability of the forest resource should be recovered from forest operators and included as a cost of harvesting. To the extent that forest regeneration is a responsibility of private operators, the associated costs should be deducted from the base for resource valuation.

As a separate issue, the base for a volume-related fee should attempt to measure the value of the resource itself after allowing for harvesting and processing costs, including a return on the assets employed in harvesting and processing. The current sliding scale system is designed to make a rough attempt at identifying this value, but is relatively insensitive both to variations in price and to variations in the costs of harvesting among different forestry operators.

The appropriate level for a tax based on the value of the forest resource will be subject to the same considerations as for mining taxes. Once the base for the tax or "price" has been determined, the operator's share of the "price" in Ontario must be compared with the operator's share of the "price" in other jurisdictions supplying the same product.

Farming

Virtually every tax that applies to the agricultural sector contains special provisions that distinguish the treatment of agriculture from that of other economic sectors. The major special provisions and issue areas are:

- Property assessment and taxation for municipal tax purposes. Agricultural property is not assessed on the basis of its full market value; it is assessed on the basis of values determined in farmer-to-farmer sales of land only. In addition, municipal and education taxes on farming land qualify for a special Farm Tax Rebate equal to 75% of the taxes paid. The farmhouse and one acre of the farmland are subject to full property taxes.

- Capital-gains taxation. Capital gains on farming property are eligible for a special $500,000 exemption.

- Deductibility of losses for income tax purposes. In determining the eligibility of a taxpayer to deduct farm losses from other income, a judgement must be made as to whether the purpose of the farm operation is to earn an income.

Concerns about the impact of property taxes on farming have come up repeatedly in Fair Tax Commission tax forces as well as in the Property Tax Working Group (Fair Tax Commission 1992c).

The working group recommended that property tax assistance for farms be considered in the context of a broader review of public support for agriculture as an industry in general, and for family farming in particular.

Special provisions for farmers raise questions concerning the definition of a farmer, the relationship between these particular provisions and the public policy objective which they are intended to support, and the effectiveness of tax-delivered support compared with that of direct spending alternatives.

Public support for farming may be based on one or more of three objectives:

- The preservation of agricultural land.
- The maintenance of our productive capacity in agriculture.
- The protection of family farming as a way of life.

Some of the issues in farm taxation may be addressed indirectly as a result of more broadly based reforms aimed at improving the fairness of the tax system as a whole. For example, reform of the education funding system and the development of a new system for property assessment might eliminate the need for special provisions for farming in the local property tax system.

Other special provisions should be evaluated in relation to the three objectives described above and their effectiveness measured against the effectiveness of non-tax programs designed to achieve the same objectives.

VI. The Taxation Policy Process

The Fair Tax Commission was specifically asked as part of its mandate to involve people who are traditionally not involved in the process of developing tax policy. Finding ongoing ways to involve people who are outside the circle of experts who now dominate the tax policy debate is a key goal of the commission.

One of the major underlying issues in taxation policy concerns the extent of public involvement in, and awareness of, the determination of taxation policy. Taxation policies have evolved over time, from budget to budget as successive provincial ministers have responded to economic circumstances, fiscal needs and other public policy pressures. These budgets are developed largely behind closed doors. There is no regular tax fairness audit that might correspond to the expenditure effectiveness review conducted by the Provincial Auditor. The fairness of the overall system is examined only periodically through the work of commissions or legislative committees. As a result, there is little or no ongoing accountability by government for the fairness of the tax system.

The use of the tax system to achieve other policy objectives is an important issue that is given little public scrutiny in the current taxation policy and budgetary processes. The costs of policies and programs in the tax system that are designed as substitutes for public subsidies receive extensive public attention only when they are introduced.

In today's atmosphere of economic constraint, this protects many of the benefits provided through the tax system from the same tougher scrutiny and exposure to cuts to which visible expenditure programs are subjected.

Fair Tax Commission tax forces and working group members have identified opening up of the taxation policy process and provision of better and more accessible information about the tax system as crucial elements in improving the fairness of the tax system.

Four objectives for fairness in the taxation decision process have been identified in a study for the FTC of the tax policy process:

- To provide reasonable public opportunities for interest groups and the public to make known their views.
- To provide reasonable opportunities for members of the Legislature to scrutinize the budget and to hold the government accountable for its contents.
- To ensure that the cabinet and the Ontario Minister of Finance are able to make effective and timely decisions on taxation policy.
- To establish reasonable and open opportunities for independent analysis and criticism and to provide objective data upon which such analysis might be based (Doern 1993).

While the study concludes that the budget process has become fairer over the past decade, it also concludes that secrecy remains an obstacle to fairness and that insufficient objective information on the tax system and its impact is available to the public. This prevents the process from moving significantly beyond its current status as a fundamentally political partisan debate.

VII. The Role of Public Input in the Commission's Work

A major component of the commission's mandate is to involve a broad cross section of Ontarians in its search for tax fairness, particularly those not traditionally involved in the development of tax policy.

The Ontario Minister of Finance demonstrated a commitment to this process by appointing individuals with a wide variety of perspectives to the eight working groups.

The commission's consultation program has engaged hundreds of people from 13 communities in ongoing discussion, debate and dialogue. This information has been brought to the table, along with more than a thousand letters and submissions from across the province.

When coming to decisions about appropriate recommendations to improve the fairness of our tax system, the commission will consider both fairness goals and the constraints imposed by Ontario's economic and constitutional position. These factors will be balanced with our collective desire to prosper in an increasingly interdependent global economy.

Input from the public continues to make the commission aware of the full range of tax issues and makes a valuable contribution to the discussion of what is fair when considering the impact of these issues on the lives of the people who live and work in this province.

Public hearings will take place across the province in April, May and June. All letters and submissions received before June 30 will be considered by the commission in its deliberations. The commission will then begin work on its final report, due to be submitted to the Minister in the fall of 1993.

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